THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

ANTM - Q4 2016 Anthem Inc Earnings Call

EVENT DATE/TIME: FEBRUARY 01, 2017 / 1:30PM GMT

CORPORATE PARTICIPANTS

Doug Simpson *Anthem, Inc. - IR*

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

John Gallina *Anthem, Inc. - EVP & CFO*

CONFERENCE CALL PARTICIPANTS

Kevin Fischbeck *Bank of America Merrill Lynch - Analyst*

Josh Raskin *Barclays Capital - Analyst*

Ana Gupte *Leerink Partners - Analyst*

Christine Arnold *Cowen & Company - Analyst*

Austin Bohlig *Piper Jaffray - Analyst*

A.J. Rice *UBS - Analyst*

Justin Lake *Wolfe Research - Analyst*

Ralph Giacobbe *Citi - Analyst*

Matthew Borsch *Goldman Sachs - Analyst*

Dave Windley *Jefferies & Co. - Analyst*

Gary Taylor *JPMorgan Chase - Analyst*

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by and welcome to the Anthem fourth-quarter results 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. - IR*

Good morning and welcome to Anthem's fourth-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 John Gallina, our CFO. Joe will provide an update on recent developments and our 2016 financial results. John will then discuss our business unit performance and other key financial metrics and then Joe will discuss our 2017 outlook and provide some incremental commentary on earnings expectations beyond 2017. We will then be 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 www.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 fourth-quarter 2016 GAAP earnings per share of $1.37 and adjusted earnings per share of $1.76 with membership and revenue tracking above our previous expectations. For the full-year 2016, GAAP earnings per share was

$9.21 and adjusted earnings per share was $11 representing year-over-year growth of 8.3%. As we previously stated in an 8-K filed a few weeks ago, we increased our adjusted earnings-per-share outlook from $10.80 to $11 primarily driven by a retroactive change in the minimum MLR calculation under California's Medicaid expansion program.

Before John and I discuss the details of our 2016 financials and our earnings outlook, I'd like to start by discussing our perspective on the changing political landscape. Anthem remains actively engaged in the policymaking process on behalf of our customers at both a federal and state level. We believe the health insurance industry in general and Anthem in particular is part of the solution in addressing the major issues of access, quality and affordability.

As we have said repeatedly, the individual market under ACA has not been working well and changes are needed to ensure stability. We are hopeful that Congress and the administration are taking a measured approach to preparing the ACA that seeks a smooth transition to prevent health coverage disruptions for Americans whenever possible. Changes are needed to ensure both a stable and sustainable individual market and a smooth transition for consumers. Specifically steps must be taken to address two key shortcomings in the current market -- risk pool integrity and affordability.

Suggested changes include repeal the health insurance tax and extend transitional or otherwise known as grandmother plans indefinitely to improve affordability; decrease the number of special enrollment periods and requiring pre-verification of eligibility; address challenges with nonpayment of premium grace periods by requiring consumers to pay outstanding premiums before enrolling in new coverage with the same health plan; prohibit third parties with financial interests from steering individuals to the individual market who are eligible for Medicare and/or Medicaid; maintain risk adjustment changes included in the 2018 notice of benefit and payment parameters to balance incentives for both healthy and moderately unhealthy enrollees.

While the direction in Washington has been positive, we still need certainty about short-term fixes in order to determine the extent of our participation in the individual market in 2018 and we will be watching developments closely in the first half of 2017 as we evaluate our longer-term strategy for the health insurance exchanges.

Now to discuss consolidated financials we reported this morning. Our fourth-quarter adjusted EPS of $1.76 was ahead of our previous expectations with membership and revenue tracking well. Within membership, both fully insured and self-funded enrollment came in ahead of expectations as we ended the fourth quarter with over 39.9 million members. For the full-year 2016, this represents total membership growth of over 1.3 million members or 3.4%. Specifically, insured enrollment was ahead of our previous expectations as our commercial group insured and Medicaid enrollment grew more than expected during the quarter.

We currently serve over 6.5 million Medicaid members, representing growth of 613,000 or a 10.4% increase in just 2016 alone. As expected, individual enrollment declined by 93,000 and we ended the fourth quarter with just over 1.3 million individual ACA-compliant lives, 839,000 of which came from the individual exchanges. Our membership results in 2016 translated into better-than-expected operating revenues of $84.2 billion, an increase of $5.8 billion or 7.4% versus the full-year 2015.

The increase reflects the strong enrollment growth in the government business and additional premium revenue to cover overall cost trends. Additionally, administrative fee revenue grew by 6.5% versus 2015 as the result of our self-funded membership trends. These increases were partially offset by fully-insured membership losses in our commercial business during the year. The full-year 2016 benefit ratio was 84.8%, which was better than our previous expectations primarily reflecting the impact of the retroactive change to the minimum MLR calculation under California's Medicaid expansion program. Our ratio reflected a 150 basis point increase versus the 83.3% we reported in 2015 primarily driven by higher than initially expected medical costs in the Medicaid business, notably in Iowa.

In addition, our strong membership growth contributed to the higher benefit expense ratio as the Medicaid business carries a higher ratio than the consolidated Company average. Further, the benefit expense ratio reflects the impact of higher than initially expected medical cost experience in the individual business. These increases are partially offset by lower medical costs experienced in the Medicare business.

During the quarter, cost trends overall were in line with what we had expected on the third-quarter earnings call, which reflects the impact of our medical management strategies. Our 2016 local group insured medical cost trend came in at the low end of our previously guided range of 7% to 7.5%. Our 2016 SG&A expense ratio of 14.9% was slightly higher than previously expected, but still declined by 110 basis points versus the 16% reported in 2015. The decrease versus 2015 was primarily 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.

During the quarter, our administrative costs were slightly higher than what we had expected as our previous guidance did not include costs that have been excluded from adjusted earnings per share. Additionally, the Company incurred higher-than-expected incentive compensation expense, as well as additional severance expenses to support ongoing efficiency initiatives. I'm going to turn the call over to John to discuss our business unit performance and other key financial metrics. John.

John Gallina - *Anthem, Inc. - EVP & CFO*

Thanks, Joe. In the government business, we added an additional 109,000 members during the quarter, bringing the total 2016 enrollment increase to 614,000 members representing 6.9% versus year-end 2015. The enrollment growth and pricing increases translated into 2006 in government business operating revenue of $45.5 billion, a growth of 11.4% versus 2015.

Operating margin for the government business was 3.9% in 2016, a decline of 90 basis points compared to the prior year driven by lower gross margins in the Medicaid business. As we communicated previously, we expected Medicaid margins to compress from 2015 levels due to rate actions impacting 2016. In addition, we experienced higher-than-expected claims across Medicaid business in the current year, including materially higher-than-expected costs in the recently implemented Iowa contract.

Operating margins in the fourth quarter of 4.5% were higher than expected due to the retroactive change in the minimum MLR calculation under California's Medicaid expansion business we discussed earlier. Importantly, core medical cost trends during the quarter were relatively in line with our most recent expectations.

The pipeline of opportunity for our Medicaid business remained substantial with approximately three-fourths of the pipeline in new and specialized services and the remainder in traditional Medicaid services. We continue to believe our Medicaid asset and geographic footprint is very well-positioned to capitalize on these growth opportunities over the next five years as we continuously demonstrate that we are part of the solution to addressing the challenges of rising healthcare costs for our state partners' constituents while improving quality.

Within Medicare, we are pleased with the progress the team continues to make as our 2016 margins reflected improvement versus 2015. The improvement is a direct result of investments made in our Medicare business over the past three years. We have now positioned our portfolio to grow MA in 2017, which we will discuss in more detail when we turn to our 2017 outlook.

Switching to our commercial business, our enrollment came in better than expected growing by over 700,000 members during 2016 to 30.4 million members representing growth of 2.4%. This growth translated into better-than-expected operating revenue of $38.7 billion during the year, an increase of $1.1 billion or 3% compared to 2015. Our 2016 operating margin of 8.3% compared to 7.6% in 2015, an improvement of 70 basis points. Commercial operating margins during the year reflected a lower SG&A ratio due to lower administrative costs resulting from expense efficiency initiatives, as well as fixed cost leveraging on a growing membership base.

In addition, operating margins benefited from membership growth and our self-funded product offerings, which carry a higher-than-average operating margin. These increases were offset by operating margin losses in our individual ACA-compliant business driven by higher-than-expected medical costs experienced as we have discussed previously. Within our ACA-compliant plans, our performance during the fourth quarter was generally in line with previous expectations. We continue to experience higher-than-expected costs from members with chronic conditions.

Next, I'd like to discuss the balance sheet. Consistent with our past practice, we have included a roll-forward of our medical claims payable balance in this morning's press release. For the full-year 2016, we experienced favorable prior-year reserve development of $850 million, which was

moderately better than our expectations. Our reserves continue to include a provision for average deviation in the mid to high single digits and we believe our reserve balances remain consistent and strong as of December 31, 2016.

Our days and claims payable was 41.3 days as of the end of the year, an increase of 0.7 days from the 40.6 days we reported last quarter. Our debt-to-cap ratio was 38.5% as of December 31, lower by 20 basis points from the 38.7% at the end of the third quarter, which reflects the impact of an increase in shareholders' equity as we did not repurchase any stock during the quarter.

We ended the fourth quarter with approximately $1.4 billion of cash and investments at the parent company, which was impacted by the timing of changes in intercompany funding arrangements and the settlement of intercompany receivables. Adjusted for the timing impact of these changes, cash and investments at the parent company would have totaled approximately $3.3 billion as of December 31, 2016.

Our investment portfolio was an unrealized gain position of approximately $568 million as of the end of the quarter. For the three Rs, we continue to book reinsurance as appropriate and we continue to reflect a net receivable position for risk adjusters. As we have consistently done since 2014, we have continued our conservative posture of recording a 100% valuation allowance against any unpaid receivables for the 2014, 2015 and 2016 benefit years for risk corridors. Our reported earnings have never benefited from the amounts we are due under the US Corridor program.

Now moving onto cash flow. For the full-year 2016, we reported operating cash flow of approximately $3.2 billion or 1.3 times net income, which was stronger than expected and reflects the quality of our earnings. Cash flow in the quarter totaled $275 million. As a reminder, our third-quarter operating cash flow included the favorable timing of an extra CMS payment, which had an offsetting impact on our fourth-quarter operating cash flow. We also used $171 million during the quarter for our cash dividend.

With that, I will turn the call back over to Joe to discuss our 2017 outlook and provide some incremental commentary on earnings expectations beyond 2017. Joe.

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

Thanks, John. Before we begin, it is important to note that this commentary about the 2017 outlook details reflects Anthem on a standalone basis. We expect operating revenues to grow to a range of $86.5 billion to $87.5 billion in 2017, reflecting growth in higher revenue PMPM insured membership in the government business and premium rate increases to cover overall medical cost trends. In total, we expect our enrollment to increase by about 200,000 to 400,000 in 2017.

Specifically, in commercial, we expect membership to increase by a little less than 150,000 members. Our self-funded enrollment is expected to increase by approximately 350,000 lives in 2017 with positive momentum in securing new contract wins and maintaining retention rates in the large group segment, along with expected growth in BlueCard enrollment.

While we expect another growth year in ASO, our commercial fully insured enrollment will be pressured. We expect membership declines in our individual business as individual non-ACA-compliant membership will continue to decrease. We are encouraged that the early indicators of the open enrollment activity are ahead of these expectations with a demographic mix that is consistent with our expectations.

At this time, however, we do not yet have visibility on the makeup of our renewal membership or the health of the overall risk pool. Our outlook continues to expect our individual ACA-compliant plans to be breakeven to slightly profitable in 2017. We expect local group fully insured membership losses of approximately 100,000 as members continue to transition into self-funded product offerings, albeit at a slower rate than recent years and the impact of membership declines as small group plans migrate into ACA-compliant products.

For government, we expect another year of growth with membership expected to increase by more than 150,000. We expect Medicaid to add more than 100,000 lives reflecting organic growth of new contracts implemented during 2016 and growth of existing contracts. During the year, we expect to be active participants in various RFPs as we continue to see states gravitate towards managed care to be the solution to manage the health and cost of their complex populations and services such as long-term services and support, intellectual and developmental disabilities and aged, blind and disabled.

Within our Medicare business, we are pleased to expect growth of approximately 75,000 members primarily in our Medicare Advantage product offerings. This represents faster than market average growth of 6% to 9% as we've been able to capitalize on the opportunities through an increasing number of four-star plans.

Turning to the financial metrics, the one-year waiver in the Health insurer fee in 2017 impacts all of our major financial metrics such that comparisons to 2016 on a reported basis will be distorted. We expect a 2017 consolidated MLR midpoint of 87%, an increase of 220 basis points versus 2016, largely reflecting the impact of the waiver in the health insurer fee. Aside from the fee impact, our outlook reflects the migration of members onto ACA-compliant in the small group and individual businesses, which carry a higher loss ratio. Offsetting the migration impact is an expected improvement in the individual ACA-compliant MLR as the price increases we put forward during 2016 are expected to improve the overall profitability of that book of business to be relatively breakeven to slightly profitable next year.

Finally, in our government business, we expect the medical loss ratio to be higher as we expect continued gross margin pressure in the Medicaid business primarily driven by rate actions within the Medicaid expansion population partially offset by improvement in the Iowa Medicaid contract financial performance.

In 2017, we expect local group insured medical cost trends to be generally consistent with 2016 with the exception of hepatitis C costs. Treatment costs are not expected to increase in 2017 like they did in 2016, which was driven by a change in our coverage policy at the end of 2015. As a result, we expect local group insured medical cost trends to be in the range of 6.5% to 7%.

We expect our SG&A ratio in 2017 to be 13.3% at the midpoint, a decrease of 160 basis points from the 14.9% in 2016. The decrease largely reflects the impact of the one-year waiver in the health insurer fee and the impact of Cigna transaction costs during 2016 that are not part of the 2017 outlook. To a lesser extent, our SG&A expense ratio is impacted by continued strong administrative expense control and the impact of fixed cost leveraging while we grow membership and revenue, all of which more than offset the return of one-time expense reductions made during 2016.

Below the line, we expect investment income of approximately $740 million and interest expense of approximately $660 million. Note that our interest expense projection does not include the costs we expect to incur related to the bridge loan financing we have in place for the pending Cigna transaction. We also currently expect our tax rate to be in the range of 33% to 35% for the year, an improvement versus 2016, which was also driven by the waiver of the fee.

Operating cash flow is expected to increase to a more normal level in 2017 as the impact from the receipt of the final reinsurance payment in our individual ACA-compliant plans will be roughly offset by Medicaid rebate payments back to certain state partners. For the full year, we expect operating cash flow to be greater than $3.5 billion.

We expect some benefit from the impact of capital deployment activities with the majority of the benefit recognized in the second half of the year. Our outlook assumes we resume share buyback activity during the second quarter of 2017 at a previously normal level of $1.5 billion to $2 billion during the year. As a result, we currently expect our average share count for the year to be in the range of 262 million to 266 million shares.

To conclude, our 2017 GAAP earnings-per-share estimate is greater than $11.11. Our adjusted earnings-per-share outlook is greater than $11.50. The difference between these two estimates is the exclusion of the amortization of deal-related intangibles. It is important to note that our 2017 outlook does not include any benefits related to improved pharmaceutical pricing, which we believe we are entitled to under our current contract with ESI. It also does not include any potential assessments related to Penn Treaty, which we would be required to approve when the judge gives a liquidation order. Current estimates for our portion of the overall assessment is in the range of $190 million to $220 million, which we would exclude from adjusted EPS if incurred.

Looking longer term beyond 2017, we are targeting an improvement in earnings growth rates toward the upper single to lower double-digit range driven by growth in our government and commercial businesses coupled with effective use of capital deployment. Within government, we are confident that our business will be able to capitalize on the opportunities to increase enrollment.

As we've previously discussed, our best-in-class Medicaid asset is very well-positioned to capture its fair share of the significant pipeline of opportunity. Our reconstructed Medicare asset is now well-positioned to meaningfully grow membership with operating margins in our targeted range going forward. We expect our growth rates to exceed market average over the next few years as we continue to increase the percentage of members in four-star plans.

Switching to commercial, we expect to continue our strong track record of growing self-funded enrollment. We are working to improve the recent trends in our commercial fully insured enrollment. We have reviewed our competitive position in our markets and we've identified various growth opportunities. For example, we are focused on driving improved penetration rates of specialty offerings to raise the earnings contribution from self-funded membership. While we have improved the penetration of certain products like dental in recent years, we know that we are not capturing the full wallet share potential of certain self-funded customers as we are meaningfully underpenetrated in the cross-selling of our specialty integrated healthcare management and stoploss product offerings.

In recent years, we have managed through a meaningful headwind as employer groups migrated from a fully-insured product into a self-funded product at a lower earnings contribution per member. We are focused on driving improved penetration rates to help narrow the earnings contribution differential between these two funding types. In addition, we are also focused on optimizing our products and networks to improve our local group fully insured trends.

Across both business units, we expect to remain disciplined with our administrative expenses. By appropriately prioritizing investments, we believe we will capitalize on these growth opportunities while optimizing our cost structure. We also expect to be a diligent and effective steward of shareholder capital to improve our growth potential. Our balance sheet is strong and we will be opportunistic in both M&A and share buyback activity.

Lastly, there is a significant and growing opportunity to improve our competitive position and financial earnings potential with a new and improved pharmacy contract. We are pleased that we've been able to grow membership in spite of paying above-market rates to our PBM vendor. Getting this issue resolved will solidify our leading market position. As we have committed, we expect to finalize our scenario planning and inform the market by the end of 2017 about our long-term pharmacy strategy while the litigation with our current vendor continues. With that, operator, please open the queue for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Kevin Fischbeck, Bank of America.

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

Thanks. That's helpful, the long-term commentary. I guess maybe just following up on that, one clarification first and then a question on it. I think you said high single-digit, low double-digit earnings growth. Did you mean EPS growth, not earnings growth? And then the other question would be, when you look at the three products, Medicare, Medicaid and commercial, where are you versus that long-term target margin in each product? Do you see pressure in any of them? Do you see margin opportunity on any of them?

John Gallina - *Anthem, Inc. - EVP & CFO*

Thank you, Kevin. In terms of the high single digits, low double digit, that was on an EPS basis so that would include a little bit of capital deployment associated with that on a long-term basis. Associated with the second part of your question, the Medicare, we've done extremely well over the past few years trying to get that platform fixed and get it corrected and we are very close to target margins in that block of business right now,

albeit at a lower membership level than we would like to have on a long-term basis. We think that there is some significant opportunities for growing the top line and maintaining those target margins.

On the Medicaid, it's a mixed bag. The Medicaid expansion we've done extraordinarily well and we've actually been earning above-target margins and that's one of the headwinds we have going into 2017 is the pricing associated with the Medicaid expansion book of business coming back down into target margin levels.

And then on the commercial, we think there's a lot of opportunities associated with wallet share, doing a better job of penetrating our large group ASO block of business, as well as trying to retain and maintain our ACA-complaint and non-ACA-compliant small group books of business. So it's not a simple question, but we think we are very well-positioned for growth, but we are doing pretty well right now.

Operator

Josh Raskin, Barclays.

Josh Raskin - *Barclays Capital - Analyst*

Good morning. First, just a clarification. If you could quantify the impact of the HIF holiday on the MLR, the G&A and the revenues. And then my second question is just the buybacks or I guess the share count coming down 2 million to 6 million shares seems relatively conservative in light of the 3.3 million of parent cash, not to mention the $3.5 billion that you will generate over the year. And I understand your plan is to start in 2Q, but I think, Joe, you said you would resume normal share repurchase activities and I guess I'm just curious why you wouldn't resume a more aggressive stance in light of the pause you've taken over the last two years? Is there pending M&A? Is there something else that you want to provide that additional flexibility?

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

Let me answer the second question. Maybe John can pick up the first question and get into some detail, but I think I also underscored the use of the word opportunistic. I think your point is a good one in terms of the commentary, which is we are certainly going to target a certain level, but I believe if we see the opportunity present itself, we may become, use the word, more aggressive. So I wouldn't rule it out, but again being opportunistic is critical.

And then to your point, that certainly gives us powder with respect to other opportunities in and around M&A and investments in other capital deployment arenas that would pursue certain growth opportunities for the Company that we think would be very vital to our success going forward. John.

John Gallina - *Anthem, Inc. - EVP & CFO*

Sure. Josh, on the other question on the HIF holiday, as we had indicated in our prepared comments, that makes many of our metrics non-comparable on a reported basis year-over-year. I would look at it this way. In 2016, the amount of Health insurer fee that Anthem is going to be required to pay in this expense is approximately $1.2 billion and we've had a very cognizant approach to try to ensure that our pricing associated with that maintained a constant EPS number. So we are pressing for the fee, the tax gross-up and the non-deductibility of that again and again. So you can then calculate the impacts.

Once you go through that, you will see that the MLR ratio year-over-year is going up nominally, really not much at all. The single biggest driver by far is the fee. The G&A ratio is coming down a bit, but the single biggest driver of it coming down and the magnitude it's coming down is the fee.

And then you also have to realize that in the competitive environment that we work in, occasionally there can be some fungibility associated with the pricing and how much is fee versus other things, as well as that, in the Medicare Advantage area, that we have taken the waiver of the fee and we we've baked it into the product design and benefits to the customers so that the members actually enjoy that. So a lot of moving parts, but the vast majority of our reported movement is the fee.

Operator

Ana Gupte, Leerink Partners.

Ana Gupte - *Leerink Partners - Analyst*

Good morning. The first question was can you just quantify the magnitude of your loss on Iowa in 2016 and where your margins ended up and then what is your rate increase that you are expecting? Will it be in Jan or in July?

John Gallina - *Anthem, Inc. - EVP & CFO*

Thank you for the inquiry. In terms of -- I will answer the second part first. The renewal is due on July 1 and that's when we would expect to obtain actuarially justified rates associated with Iowa. We are still negotiating with the state of Iowa in terms of the rate. So it is premature to provide a specific point estimate or data element on that other than to say that we are requesting actuarially justified rates.

In terms of 2016, as we had stated I think in the second-quarter call, that the expense, the medical loss ratio was a good 20 percentage points higher than we expected. It did come down a bit over the rest of the year as some of our medical management initiatives and some of our other cost-of-care initiatives went into place, but it still ended up at a loss in the 10 to 15 percentage points higher than we would have expected based on that block of business.

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

I might underscore to add on to John's commentary, we continue to be in dialogue with the Governor's office. As you may know, there has been a transition -- there is a transition now in process regarding the appointment of a new Governor. The Lieutenant Governor is moving into the office and we are in dialogue with her office and we are hopeful that that continued dialogue in and around the needs that we have for I guess call it correcting the inadequacy will produce results. But, again, we will not know that for still some period of time, but, again, we remain hopeful that the dialogue will produce intended results.

Operator

Christine Arnold, Cowen.

Christine Arnold - *Cowen & Company - Analyst*

You mentioned some of your individual enrollment was coming in higher than expected. Where do you think you are landing as of now? I know open enrollment just ended last night, but where do you think your individual enrollment wound up entering this year? And if this turns out to be another year of losses without some meaningful legislation -- I know we are hopeful that there will be meaningful legislation and administrative action -- will you exit for 2018?

John Gallina - *Anthem, Inc. - EVP & CFO*

Christine, let me answer your question on enrollment and then I know Joe has some commentary on the second part of your question. In terms of the enrollment, even though open enrollment ended last night, that only provides us one portion of the equation and that's the applications and we monitor that very closely. Applications are a little bit stronger, a little bit better than we expected, not dramatically, but a little bit stronger and as we look at the demographics associated with those applications, whether it's age and income distribution, subsidy eligibility, metal levels, various things like that, we are very comfortable with the overall amount of applications as compared to what we've planned for.

What we do not know and what no one knows at this point is how the renewals work and what percent renewals that you will retain versus who jumps to another plan versus who goes somewhere else. And so it's really premature to give an exact membership number because it's really unknown, but I will say the applications were a little bit stronger than we had anticipated. Joe.

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

Christine, let me deal with our outlook with respect to how we might further engage in the market or retract. As I said in the third-quarter earnings call that we are very carefully evaluating how the marketplace will evolve related to the legislative and regulatory changes that may be enacted as certain regulators and legislators seek stabilization of the marketplace. We have weighed in considerably and continue to do so with all the leadership in Congress and I can tell you that we have some very specific asks and I commented on those asks in my remarks, but also there are probably about four or five other expectations and what all that maps to is a set of expectations that we will be monitoring very carefully to see if they are implemented such that, as we approach the end of the first half of this year, we will have to make decisions, as I said on the last earnings call, whether or not we surgically extract ourselves from certain rating regions or quite frankly, even on a larger scale, dependent on the stability of the marketplace.

We believe that this year we have a I would call it maybe a fairly modest outlook in terms of being able to pursue or accomplish a profitability that would be -- recognized stability because of the price increases that we achieved for this year's entry into the marketplace. But if we can't see stability going into 2018 with respect to either pricing, product or the overall rules of engagement, then we will begin making some very conscious decisions with respect to extracting ourselves.

We will have more to say by our Q2 call. I think it's fair to say that we still are in a state of evaluation, but I think I wanted to share with you that we are very mindful, very vigilant and we will make the right decisions to protect the business with respect to moving into the next year.

Conversely, as I said, I believe and we do have some positive indicators that stabilization could very likely occur and given the advocacy that's occurring on behalf of the industry and I am again hopeful that our recommendations will be looked at very carefully and adopted. But, again, it remains to be seen and we will say more as we end up our Q2 call. Thank you, Christine, for that question.

Operator

Sarah James, Piper Jaffray.

Austin Bohlig - *Piper Jaffray - Analyst*

This is actually Austin on for Sarah. Can you go into a little more detail on the California minimum MLR retroactive change? Is there any offset to this under the legal settlement and -- that offer margin targets for California Medicaid?

John Gallina - *Anthem, Inc. - EVP & CFO*

Thank you, Austin. The California Medicaid Retroactive Adjustment to the medical loss ratio calculation, just for a little bit of clarification, had to do with how taxes are treated and getting the definition within the California Medicaid arena to more closely align with the definition that already existed as part of the ACA MLR rebate calculation.

In terms of -- that was the primary driver of us going from $10.80 to $11 for 2016. We were already in an MLR rebate position in California when this occurred and so what had happened was once we re-performed the calculation under the corrected rules, under the corrected definition, it allowed us to reduce the amount of liability we had on the books associated with the MLR rebate.

So there's no offset -- or it's just that we performed the calculation. We will settle the MLR rebate with the state in 2017, as was previously prescribed and it allowed us to be the primary driver of adding $0.20 per share to the shareholders here at the end of 2016.

Operator

A.J. Rice, UBS.

A.J. Rice - *UBS - Analyst*

Maybe a question and a point of clarification. You didn't really comment too much on the Cigna deal and you probably can't, but I'm just looking for clarification. The extension of the agreement, is that something that you can unilaterally ask for or does Cigna have to sign off on that? And then I thought the judge had indicated in the case that we would probably hear something by the end of January. Obviously, that has passed. Has there been any communication as to either why the delay or the updated timing?

And then I will just ask my point of clarification. On your comment about local group medical cost trend, you are expecting it to be down. You referenced this hep C change. Is that the only thing that's different, otherwise your medical cost trend would be, expectation this year, versus 2016 and is that related to Express in any way or is that strictly something you guys did unilaterally?

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

Regarding the Cigna deal and the extension, that is a unilateral determination decision on our part and obviously, we've already expressed our exercise of that position with respect to a filing recently, so we are moving forward. And with respect to the judge, it's certainly not uncommon and we are not bothered by the length of time because it is a very complicated case, a lot of moving parts and the submittals were very extensive. So certainly again we are not bothered by it. Obviously, we certainly would like a decision soon so we can move on, and obviously we are still hopeful too, but again I think give the judge her due in terms of the thoughtful process she has to go through. We are very confident that we should be getting a decision very soon. You may recall she did say somewhere in the end of the month timeframe and I think it's come upon us, so we will see when it happens, hopefully in the coming days.

John Gallina - *Anthem, Inc. - EVP & CFO*

Your specific question on trend. So just to clarify. Trend for 2016 came in relatively in line with our expectations. I feel very, very good about that, maybe closer to the low end of the range that we provided at the beginning of 2016 and then as we look into 2017 in general, the trend is relatively stable year-over-year except for the one item that you pointed out and that was the hepatitis C drug spend. So that has nothing to do with Express Scripts.

In 2015, we changed the coverage options and allowed a broader coverage of people that qualified for hep C treatment. We proactively went out at that point in time and did some rebate contracting and various other things that really mitigated the significant increase that we saw in 2016. The increases would have been even greater without the proactive steps we took.

Now we believe that the cost structure associated with that, the utilization associated with that is going to stay flat from 2016 to 2017. It's just that by staying flat from 2016 to 2017, it means we did not have the increase that we saw from 2015 to 2016, so it is impacting our overall trend calculation. So at the end of the day, trend is really stable year-over-year; we just have the mathematical dynamic of what's going on with hepatitis C. Thank you for the question.

Operator

Justin Lake, Wolfe Research.

Justin Lake - *Wolfe Research - Analyst*

Just had one clarification and one question. First, the follow-up is can you give us the precise number of ACA individual compliant and non-compliant individual members assumed in the overall 2017 membership guidance? And then can you give us some more color on the PBM? Specifically is the RFP already out in the market yet and then you said you would have a decision by the end of the year. Would that include sharing with us the expected drug cost savings estimates and the expected economic impact to the business when a new deal starts? Thanks.

John Gallina - *Anthem, Inc. - EVP & CFO*

In terms of the individual ACA compliance, just to give you a frame of reference, it's about 80%, just a tiny bit over 80% is ACA compliant in our plan, which means approaching 20% is non-compliant. And then in terms of -- what was the question again; could you repeat question on the PBM?

Justin Lake - *Wolfe Research - Analyst*

Sure. Is the RFP out in the market yet? And then you said you would have a decision by the end of the year. Would that include sharing with us drug cost savings estimates and the expected economic impact to the business when a new deal starts relative to what you had said before?

John Gallina - *Anthem, Inc. - EVP & CFO*

Yes, so the RFP is not yet out; although it's imminent. And as we have stated previously, we expect to go through and be very thoughtful in our approach and by the fourth quarter of 2017 provide more clarity to all of you associated with our future pharmacy strategy. At that point in time, we would expect to provide some quantification and clarification associated with what the economics are, which could be a 2020-type upside at that point in time.

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

But still the base that we are building off of in terms of what we've communicated many times is $3 billion savings per year. Obviously escalated over time, so I think we will certainly be able to give you some line of sight regarding $3 billion as a base and then how that might improve and leading up to 2020.

John Gallina - *Anthem, Inc. - EVP & CFO*

Yes, how much of that is passed back to the customer and provides affordability aspects versus how much is retained by the shareholders.

Operator

Ralph Giacobbe, Citi.

Ralph Giacobbe - *Citi - Analyst*

Just wanted to clarify first on the long-term guidance. Is it fair to back away from that $14 EPS number at this point just considering the guide for 2017 and your growth targets that you laid out? And then my question was more around the components of trend guidance, if you could maybe break those down for us and maybe put it in the context of -- look, I certainly understand that trend came in at the lower end of the 7% to 7.5% range and even if hep C was that 50 bps, it doesn't suggest the typical cushion of that expectation of potential trend uptick in that 50 to 100 bps range. So if you could maybe reconcile for that as well? Thanks.

John Gallina - *Anthem, Inc. - EVP & CFO*

So in terms of the $14, we talked about some of the headwinds that we are facing on the third-quarter call and those headwinds are still very real and we continue to work through them. Commercial insured mix was a headwind, the most significant of which was the ACA exchanges. The fact that there were supposed to be 26 million people enrolled in exchanges by 2018 and we are at far, far short of half of that from a basis within the country and what the impact is on us.

Clearly we are keeping our foot on the gas. We are trying to do everything possible in order to bridge the gap, but we want to ensure that everyone realized back 90 days ago that these headwinds were significant and we may not be able to completely overcome them, but we've got a lot of things going on that are going very, very, very well. Medicaid is ahead. We talked about Medicare given the great growth that we have with that and all of this is without the PBM having any real upside and the $3 billion we talked about. So we have not declared specifics on 2018 yet; a little premature to do that, but the headwinds are still very real, but we are working very hard to overcome as many of them as we possibly can.

And then on your trend question, just say that we really don't go into specific trend information associated with each type of procedure, each type of process, but, as I said, the overall trend is relatively consistent year-over-year except for the hep C movement in terms of how that's impacting it. So you can assume the trend is normally unit price-driven. That's the most significant driver of it on a year-over-year basis. Our utilization, we track that very closely. That remains pretty much in line with our expectations and our medical management, our provider collaboration, there's various other things have done a really nice job of keeping the utilization patterns fairly constant and fairly low movement year-over-year. So it is predominately price.

Operator

Matthew Borsch, Goldman Sachs.

Matthew Borsch - *Goldman Sachs - Analyst*

Good morning. Let me ask about the Medicare Advantage and drug plan advance notice. Are there particular elements or factors that you will be looking for when that notice comes out? And just, by the way, I'm curious on timing, whether you expect that will be today or tomorrow.

John Gallina - *Anthem, Inc. - EVP & CFO*

Well, how about if I say we expect it to be this week? It's with anything else, we certainly do expect it to be imminent and if it came out either today or tomorrow, neither of those would be a surprise. But, as you know, with all those things, the devil is always in the details. We really need to evaluate it. We need to understand how it impacts various aspects of our business and various aspects of our membership. We are cautiously optimistic. Like I said before, our Medicare asset is a reconstructed asset really poised for growth and we feel very, very good about where we are

going to be as a company in the Medicare and Medicare Advantage areas specifically over the next several years. So tomorrow is just one piece of the puzzle, but until we actually see the details, it's a little premature to declare anything.

Operator

Dave Windley, Jefferies.

Dave Windley - *Jefferies & Co. - Analyst*

Wanted to ask a question on SG&A. I think early in the year you had talked about not only the administrative efficiency savings, but also pay-for-performance environment and insinuated some comp cost cuts and I think that comp side of it was about half. I guess I'm curious now at the end of the year how that progressed the balance of sustainable cost cuts through admin efficiency versus comp that you need to reinstate. And then the final part of this would be how do you think the SG&A base is positioned or structured to support either of your bigger outcomes, the deal closing with Cigna or your intent around perhaps some alternative strategy on the PBM? Thanks.

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

Great. Let me respond to the comp question and underscore that what we referenced during the year is that our annual incentive plan is at risk, fully at risk and we made a conscious decision in terms of the modeling that our award scheme would be based on obviously successful achievement of our expectations and that we also balanced the payouts related to our support of the shareholder interest and therefore, if we did not achieve expectations, then, of course, our incentive plan would be cut accordingly, which midyear we signaled that we were very intentional about that and in fact, as the year progressed, we were able to witness, because of the all-in commitments of management, that we were significantly improving our SG&A performance.

There were other uptakes in the business model and at the end of the year, we were able to provide advanced annual incentive plan payouts above and beyond what was forecasted in the middle of the year. The point being that it's incentive-based, it is truly at risk. Comp as a base wasn't affected, but again I'm very proud of the fact that we were able to effectively control SG&A, as well as bring in other advantages and performance improvements to the Company that allowed us to significantly award our leadership teams with the incentive payments necessary for recognition. So all in, we are very proud of how we managed it and then the outcome is the result of the management process of our annual incentive plan model.

John Gallina - *Anthem, Inc. - EVP & CFO*

Dave, just to give you maybe a little more specificity associated with your question on the back of Joe's response. The fourth-quarter SG&A ratio was a little bit higher than what we had initially stated, but when you take a step back and look at the entire year, it's still about half of the savings or half of the decrease from the initial SG&A guidance back at the beginning of 2016 is nonrecurring and maybe half is operational efficiencies along with fixed cost leveraging. So even though we did increase the amount of compensation expense here in the fourth quarter, we are still below target on that and so it still is a headwind as we get into 2017.

Associated with the operational efficiencies, there's been a lot of very successful projects that have been done here over the past few years. Our higher accuracy of auto adjudication rates of claims continue to go up year-over-year. Our claim cycle time decreased. Those are things that actually improve the accuracy of our claims payment process and we do it in a more cost-effective and cost-efficient manner just as two examples of things where part of these savings in 2016 are recurring and will inure and be part of our run rate for 2017. So it's a bit of a mixed bag, but, as Joe said, we are very proud of how we finished 2016 and think we are heading into 2017 with some nice momentum.

Operator

Gary Taylor, JPMorgan.

Gary Taylor - *JPMorgan Chase - Analyst*

Like everyone else, I have one actual clarification than a question. Just wanted to clarify. John, I thought you said on the three R risk adjustment you continue to run a net receivable position as you had consistently and I thought you ended 2015 in a net payable position. CMS actually paid you and that's what created a year-to-year pickup. Did I not hear that correctly?

John Gallina - *Anthem, Inc. - EVP & CFO*

We've been in a net receivable position consistently for a while. We were maybe a slight payor back in 2014, but we've been in a net receiver position most of the time since then, so hopefully that clarifies it.

Gary Taylor - *JPMorgan Chase - Analyst*

Then my question just on tax rate. So without the HIF returning to a normal tax rate in 2017, 33% to 35%, I think consensus was closer to 38%, so we just didn't do a good job modeling that because that looks pretty consistent with where you were running pre-ACA. The question is, that number even pre-ACA was 200 to 300 basis points lower than the other big five. Can you just remind us why your recurring tax rate runs a couple hundred basis points lower at least than others? Is there one obvious item to point to?

John Gallina - *Anthem, Inc. - EVP & CFO*

It's not one significant obvious item. There's many, many things that are part of the effective tax rate. You really have to look at the states and where companies make money and what is the state tax situation. Is it a premium tax state, is it an income tax state? What is the income tax? Is it a franchise tax state? So all those things are clearly part of the variation. The investment portfolio, what percent of an investment portfolio is in tax-exempt versus taxable yields and how does that impact it? There's any fair share of permanent tax differences that occur.

We are pretty comfortable with a lot of the tax-planning strategies we've made. We all do start with the 35% rate on a pre-ACA non-HIF-type basis and I'm not positive I know all of the differences between our rate and everybody else's other than to say that we see this as a huge focus item that every time that we can do a tax-planning strategy that just inures the benefit to the shareholders. So we put a lot of time and effort and focus on taxes behind the scenes that nobody really sees and I think our effective tax rate helps confirm that.

Operator

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

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

Thank you, operator. Thanks for your questions. As a company, we are committed to confronting our healthcare system's challenges and we are focused on expanding access to high-quality affordable healthcare for our customers. I also want to thank all of our associates for their continued commitment to serving our 39.9 million members every day. Thank you for your interest in Anthem and we look forward to speaking with you soon at upcoming conferences.

Operator

Ladies and gentlemen, this conference will be available for replay after 11 AM Eastern time today through February 15. You may access the AT&T teleconference replay system at any time by dialing 1-800-475-6701 and entering the access code 403150. International participants dial 320-365-3844.

Those numbers once again are 1-800-475-6701 or 320-365-3844 with the access code 403150. That does conclude your conference for today. Thank you for your participation and for using AT&T Executive Teleconference. You may now disconnect.