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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 third-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 an overview of our third-quarter 2016 results and our updated 2016 full-year outlook. Then John will walk through the financial details and provide some incremental commentary on 2017 before Joe closes with some longer-term strategic commentary. 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 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 third-quarter 2016 GAAP earnings per share of $2.30. Adjusted earnings per share was $2.45, consistent with our previous expectations.

Within membership we continue to post strong fully-insured and self-funded enrollment results as we ended the third quarter with over 39.9 million members. We grew an additional 160,000 lives during the quarter bringing our year-to-date enrollment growth to 1.3 million lives or 3.4%.

Specifically, insured enrollment increased by 39,000 lives during the quarter as our Medicaid business grew by 81,000 lives to over 6.4 million members. Since closing the Amerigroup transaction in 2012, we have grown Medicaid enrollment by nearly 1.9 million lives or 41% including growth of approximately 800,000 lives for Medicaid expansion.

Within commercial, our insured enrollment came in slightly ahead of expectations as local group fully-insured membership tracked well, particularly in the large group marketplace. Our public exchange enrollment declined by a less than expected 34,000 during the quarter to 889,000 lives. Our self-funded business increased by 121,000 during the quarter, reflecting the impact of enrollment growth from existing accounts and recently awarded contracts.

Our solid membership results during the year translated into better-than-expected operating revenue of $21.1 billion during the quarter, an increase of $1.4 billion, or 6.8% versus third quarter of 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 6.4% versus the prior-year quarter as a result of our strong self-funded membership trends. These increases were partially offset by fully insured membership losses in our commercial business.

The third-quarter 2016 benefit expense ratio was in line with our previous expectations at 85.5%, an increase of 190 basis points versus the prior year. The year-over-year increase was primarily driven by the Medicaid business as higher than expected medical cost experience, notably in Iowa, has exceeded the net impact of annual premium rate adjustments made over the last 12 months.

In addition, it reflects the impact of growth in membership as 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. These increases were partially offset by the timing of lower medical cost experience in the local group business.

Our SG&A expense ratio was also in line with expectations at 14.8% in the third quarter, a decrease of 80 basis points from the third quarter of 2015. The decrease 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.

Turning to discuss the third-quarter financial performance of our business units, in the government business we added 92,000 members during the quarter and grew year-over-year revenue by 10.9% to nearly $11.5 billion. As a reminder, our third-quarter results include the impact of the addition of the Iowa contract which was implemented on April 1.

Operating margins for the government business were 4.2% during the third quarter, a decline of 190 basis points versus the prior-year quarter, driven by lower gross margins in the Medicaid business. As we communicated previously we have been expecting Medicaid margins to compress from 2015 levels due to rate actions. In addition, we have been experiencing higher than expected claims across the Medicaid business in the current year, including materially higher than expected costs in the recently implemented Iowa contract.

As expected, there was a rebalancing of funding based on risk pool during the quarter. In addition, we have been informed of a retroactive rate increase which extends through June 2017 when rates will again be adjusted. Unfortunately, the recent rate increase is still inadequate given the claims experience to date.

We remain confident we can make a meaningful impact by improving the cost and quality of care in Iowa, as we've done for our other state partners. However, we will remain disciplined and only participating in markets where we receive rates that are actuarially sound.

Within Medicare, we are pleased with the progress the team continues to make, and our year-to-date margins reflect continued improvement. During the quarter CMS announced we earned Medicare Star quality ratings for 2017 consistent with our long-term strategy.

In the most recent ratings release by CMS 51% of Anthem's Medicare Advantage members will be enrolled in plans that achieve four stars or higher. This accomplishment represents significant growth from the 22% of MA members in four star plans last year. The improvement is the direct result of investments made in the Medicare program over the past three years.

Our 2016 outlook continues to expect margins to improve as the year progresses towards our expected long-range sustainable level. As we stated, since our MA restructuring began, we have positioned our portfolio to grow MA in 2017.

The pipeline of opportunity for our Medicaid business remains substantial, with an updated estimate of $81 billion in contracts to be awarded between now and 2021 in markets that we will consider targeting. Approximately three-fourths of this opportunity is in new and specialized services, with the remainder in traditional Medicaid services. We continue to believe our experience, targeted investments in critical capabilities, and geographic 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 increased by 68,000 lives during the quarter, which was slightly better than our previous expectations. Specifically, we experienced growth of 171,000 lives in our local group business, partially offset by declines of 48,000 and 54,000 lives in our national and individual businesses, respectively. These results translated into better than previously expected operating revenue of $9.7 billion, representing growth of 2.4%.

Our third-quarter operating margin of 6.6% was flat versus the third quarter of 2015. Commercial operating margins during the quarter reflected a lower SG&A ratio due to lower administrative costs resulting from expense efficiency initiatives taken by the Company, as well as fixed cost leverage on a growing membership base.

In addition our commercial business experienced a favorable timing impact of lower medical cost experience in the local group business. These increases were offset by higher medical cost experience in our individual ACA-compliant products.

Within our individual ACA-compliant plans, costs during the third quarter were marginally better than recent expectation, which is reassuring. We continue to expand higher than initially expected costs from members with chronic conditions, as we've discussed with you previously.

Overall, the financial performance in individual ACA-compliant products have been disappointing, as membership has been short of our original expectations since its inception, and operating margins have been lower than expected beginning in 2015. We believe we have taken the appropriate actions across our served markets to return to slight profitability in 2017. Clearly, 2017 is a critical year as we continue to assess the long-term viability of our exchange footprint.

We will continue to closely monitor this business, and if we do not see clear evidence of an improving environment and a path toward sustainability in the marketplace, we will likely modify our strategy in 2018. We believe both the pricing and regulatory environment need to be improved to drive toward a sustainable and affordable marketplace over the long term.

Relating to national accounts, which typically encompass the most sophisticated purchasers of coverage, we're pleased that the team continues to secure wins contributing to the track record of membership growth in 2017. We have added 602,000 lives so far in 2016, building on the growth of over 900,000 lives during the previous two years.

And now turning to our 2016 financial outlook, our third-quarter results were largely in line with the expectations we laid out during our last quarter call. We expect our full-year 2016 GAAP earnings per share to be approximately $9.28, including approximately $1.52 of negative adjustment items. On an adjusted basis we expect earnings per share to be approximately $10.80.

We now expect our 2016 operating revenue to be approximately $83.5 billion, which is at the high end of our previously guided range, reflecting the impact of slightly better enrollment trends during the quarter. Fully insured membership is expected to be in the range of 15 million to 15.1 million members, or 50,000 higher than our previous outlook, which reflects stronger than previously expected results in the commercial business.

Self-funded membership is expected to be 24.7 million members, which is at the midpoint of our range, unchanged from our previous outlook. Taken together, we are now projecting total membership growth of just over 1.1 million lives at the midpoint of our range versus where we ended in 2015.

Consistent with our expectations last quarter, we expect our medical loss ratio to be in the range of 84.9%, plus or minus 30 basis points, the SG&A ratio to be 14.5% plus or minus 30 basis points, and operating cash flow to be approximately $3 billion. We continue to expect 2016 local group medical cost trends to be in the range of 7% to 7.5%.

Our 2016 outlook continues to 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 through the first nine months of 2016. 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 nine months 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.

I'll now turn the call over to John to discuss some key financial metrics and our initial thoughts on headwinds and tailwinds in 2017. John?

John Gallina - *Anthem Inc. - CFO*

Thank you, Joe. And good morning. As Joe stated, our third-quarter results were very consistent with the expectations we laid out last quarter. In order to provide you a bit more clarity on our performance I will highlight some of our key financial metrics.

First, I would 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 nine months ended September 30, 2016, we experienced favorable prior-year reserve development of $773 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 adverse deviation and believe our reserve balances remain consistent and strong as of September 30, 2016.

Our days in claims payable was 40.6 days as of September 30, unchanged from the 40.6 days we reported last quarter. As previously discussed, and consistent with our expectations, this metric has trended down over the past year and we expect days in claims payable to be around 40 days over time.

Our debt to capital ratio was 38.7% as of September 30, down 40 basis points from the 39.1% at the end of the second quarter, which reflects the impact of an increase in shareholder equity as we did not repurchase any stock during the quarter. We ended the third 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 $983 million as of the end of the quarter.

For the three Rs we continue to book reinsurance as appropriate and continue to reflect a net receivable position for risk adjusters. We also continue our conservative posture of recording a 100% valuation allowance against any unpaid receivables for the 2014, 2015 and 2016 benefit years for risk corridors.

Moving on to cash flow, we reported operating cash flow of approximately $2.9 billion, or 1.4 times net income during the first nine months of 2016. During the quarter, we reported operating cash flow of $964 million, which was 1.6 times net income. These results include the receipt of a CMS Medicare prepayment of approximately $650 million during the third quarter.

For the full year of 2016, we continue to expect operating cash flows to be approximately $3 billion. We used $171 million during the quarter for our cash dividend, and yesterday the audit committee declared our fourth-quarter 2016 dividend of $0.65 per share to shareholders.

Now turning to 2017, we are currently working through our planning process and analyzing the impact of various expected headwinds and tailwinds. Our current view of the tailwinds include, number one, enrollment gains across Medicaid, Medicare and national and large group self-funded businesses; two, margin improvement due to improving results in our individual ACA compliant plans, the Iowa Medicaid contract, and the impact of the one-year health insurer fee moratorium in 2017; and, three, we expect to resume capital deployment activity in 2017, however the timing and magnitude is dependent upon the timing of the pending Cigna acquisition.

Potential headwinds include the return of the 2017 one-time administrative expense cuts that we made in 2016; the impact of lower local group enrollment and gross margin pressures as a result of the migration toward ACA-compliant product offerings; and, finally, we expect to experience continued margin pressure in the Medicaid business, primarily driven by rate actions within the Medicaid expansion population over the next year. Taken together, these items are expected to represent modest earnings growth in 2016.

As part of our planning process, we will continue to be focused on identifying steps to maximize our opportunities to drive improved earnings growth over time. We expect to provide more details around our 2017 outlook on our fourth-quarter conference call.

With that I'm going to turn the call back over to Joe to discuss our longer-term outlook.

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

Thank you, John. Three years ago we laid out our plan for growth, which reflected our strategy to capitalize on the substantial opportunities in the government business, while recognizing the changing nature of the commercial marketplace as a result of the implementation of the Affordable Care Act. Our plan was to establish a leadership position in the Medicaid market, stabilize our Medicare Advantage platform, and grow individual ACA-compliant and ASO enrollment and mitigate the expected pressure in the local group fully-insured segment.

Since that time we've been pleased with the growth in our Medicaid business where enrollment has grown 47% since 2013. And we are well positioned to capitalize on the $81 billion pipeline of opportunity between now and 2021 that I mentioned earlier.

In addition, we have reconfigured and upgraded our Medicare platform, as evidenced by the improvement in our margin profile and star rating performance. We expect to leverage our upgraded Medicare platform to grow MA enrollment in 2017 and beyond. Overall, the government business segment has grown nicely and now represents 54% of our consolidated Company revenue, up from 44% in 2013, and we remain very optimistic about continued growth potential in this business.

Switching to individual, as we have discussed previously, the earnings contribution from the individual ACA-compliant business represents a meaningful headwind to our original targets. The volume shortfall from our previous expectation remains substantial.

For your reference, we laid out a plan to grow individual ACA-compliant enrollment to 3 million members by 2018, using the assumption that the overall individual marketplace would be approximately 25 million members, in line with the CBO estimates. In 2016, the overall marketplace is about half of the expected size and has only grown to roughly 10 million to 11 million members. And subsequently we have grown our individual ACA-compliant enrollment to approximately 1.4 million members as of the third quarter of 2016. We are closely monitoring the progress of our actions to improve the margin profile of this business to support our low to mid single-digit margin targets of 2018.

In our self-funded business we've added 4.4 million members since 2013 as our value proposition has resonated with large employers who are focused on quality and affordability. This ASO growth has helped mitigate some of the pressure from higher-than-expected declines in our local group insured enrollment.

Across our commercial segment overall, we are generally pleased with our aggregate enrollment growth but the mix of enrollment has skewed more than expected to self-funded and fully-insured, pressuring revenue and earnings growth. Looking ahead, we still have meaningful opportunity to improve the per member EBITDA contribution from ASO by increasing that penetration of our specialty and other product offerings to help further offset the pressures on local group.

I want to spend a few moments on the pending acquisition of Cigna. We are committed to this combination which will further Anthem's vision to be American's valued health partner. This is truly a compelling opportunity to positively impact the health and well-being of our members and advance our commitment to expand access to high-quality affordable healthcare for consumers. It will also save consumers more than $2 billion in medical costs annually, directly benefiting the most vulnerable populations in the country.

I also would like to briefly address the upcoming trial with the Department of Justice, which will begin on November 21. We continue to believe the DOJ's action to sue to block the acquisition is based on a flawed analysis and a misunderstanding of the dynamic, competitive and heavily regulated healthcare landscape, and we're fully committed to challenging the DOJ's decision in court.

In terms of the court proceeding, the judge has decided to bifurcate the issues and will first hear evidence on the national accounts issue. If the judge decides in our favor on the national account issue, we will then move forward and try the other two remaining issues, with a decision on those issues being rendered before the end of January.

To summarize, we are in the process of updating our long-term growth plans and expect to target improved core earnings growth rates beyond 2017. The individual ACA-compliant headwinds and our enrollment mix discussed previously represent a meaningful challenge to achieving our $14 earnings target in 2018. We expect to provide additional clarity around our long-term growth prospects after the Cigna transaction process is complete.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Ana Gupte, Leerink Partners.

Ana Gupte - *Leerink Partners - Analyst*

My question was about the individual book. You said that there were losses this year and they continued into the quarter. Sequentially speaking, what were the losses that you estimated in second quarter? And have they gone up since then? And why are you expecting that will improve next year when the reinsurance phases out? Are you getting adequate pricing to do that?

John Gallina - *Anthem Inc. - CFO*

Hi, Ana. This is John. Thank you for the question. Associated with our individual exchange business we certainly did, in the second quarter, indicate losses, and that we expect that our operating margins are going to be on the mid single-digit loss for the year. During the third quarter the reserve development was okay. The trend has been moderated a bit and we still expect those losses in the same general range of what we said, maybe just a little bit better than what we have indicated.

In terms of 2017, reinsurance is obviously a very important factor but it's only one aspect of pricing and one aspect of the overall structure of the program. We've got rate increases that average in excess of 20% across the country. I think there have been studies that have been published that have stated that our rate increases are a little bit higher than the average rate increases.

We have made adjustments to the product offerings, we've changed networks, we've enhanced product designs. We have done many things to improve affordability of the specific product mix. We feel very good about the previous guidance that we provided. We're really targeting a small profit margin in 2017, and then returning to more closely related to target margins in 2018 and beyond.

Operator

Christine Arnold, Cowen.

Christine Arnold - *Cowen and Company - Analyst*

A couple things. On Iowa, your language there suggests that you got a rate increase but may not be adequate, and that your disciplined and you're only going to be in markets that are actuarially sound. Is there an out to get out of that if, in fact, we can't get to actuarially sound rates? And then with respect to individual, what do you think you need to see in order to feel there's sustainably into 2018? What legislatively or administratively do you want to see there?

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

Christine, good morning. This is Joe Swedish. First question regarding the out possibilities, as you know, the contract went live earlier this year and obviously we are very concerned because it has experienced a deterioration that certainly exceeded our forecast expectations regarding the medical loss ratio.

We are in the process of having deep discussions with the state regarding the possibility of adjustments. I commented in our discussions just a moment ago that we have realized some positive effect from that discussion, and, quite frankly, we're hoping for more. Unfortunately, the recent rate increase is still inadequate. Again, we're hoping for a better outcome with respect to more discussion.

With respect to the legal construct, the contract, we are examining our position. We, quite frankly, are waiting for the state to respond to the inquiries that we have submitted to them. I think it is a little early for us to maybe put commentary out regarding our legal position, given the fact that there is still administrative considerations that are working their way through the system. We are hopeful for a very positive outcome at the end of that review.

We are concerned about the actuarial soundness of the rates. And that has been expressed by all the MCOs from the get go. We are engaging in extensive process of meetings, as I mentioned, and we will continue to be deeply concerned until we get a resolution to this, and then we will weigh our options with respect to the endpoint of those negotiations with the state.

I think the second question dealt with the exchange, Christine? I'm wondering if you could restate that for me. I am sorry.

Christine Arnold - *Cowen and Company - Analyst*

It sounded like your language suggests that if 2017 doesn't go well you could change your strategy for 2018. What do you need to see administratively or legislatively in order to fix this and in order for you to feel that this is where you are going to stay for 2018?

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

On or about mid-year 2017, obviously we will be maybe coming to a conclusion on our review about how the adjustments have played out that we are expecting. To your point, what we are looking for are a variety of fixes such as elimination of the health insurance tax, or at least extending the 2017 moratorium. Another one that you probably heard quite a bit about is updating the risk adjustment model substantially to address existing imbalance that we believe deteriorates the overall risk pool.

We're also looking at additional adjustments to special enrollment periods, which we believe needs to be continually narrowed with respect to the variety and number of special enrollments. We also believe that we need to have the flexibility to develop innovative products that should go to meet the needs of our customers. Modify the grace, is another great example. And, finally, we want to work very closely with the states to make sure actuarially justified rates being approved.

Now what I just specified for you, let me just put a characterization to it that I think is very important, and that is this is a specific recipe for solutions. And we believe these recipe characteristics represent the form of a long-term sustainable and an affordable marketplace.

As I said earlier in my commentary, we believe we must see adjustments such that we can easily map to a 2018 situation of sustainability in this marketplace. And, quite frankly, given what may or may not happen, we will be evaluating the regional engagement across our markets moving into 2018.

John Gallina - *Anthem Inc. - CFO*

And, Joe, I would just like to say, obviously everything there is very appropriate but, Christine, we will be watching margins, trends, performance on a state by state and region by region basis in 2017, as well. So, certainly the decision in 2018 could be a piecemeal decision as opposed to an altogether decision.

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

I think thus far we have been very surgical in our approach and we will continue that theme. So, again, we have a hope that the sustainability that is expected and commented on quite a bit by leadership of administration actually will occur during the early stages of 2017.

Operator

A.J. Rice, UBS.

A.J. Rice - *UBS - Analyst*

I just want to follow, and I appreciate the comments of the headwinds and tailwinds and the comment about modest growth. There are three variables I just want to throw on the table. You are saying you will go from a mid single-digit loss on the exchanges or on the individual book to a positive. We got, that would represent, I think, about a $0.70 swing, roughly 6% to 7% growth in and of itself. I just also wondered, are you including anything in your comments about capital deployment when you talk about modest growth or anything on the PBM? And what is the latest thinking on that? And then just to make sure, the $10.80 is the baseline number upon which you are assuming modest growth, or is it some other number that you would adjust for as the starting point for 2016?

John Gallina - *Anthem Inc. - CFO*

AJ, thank you for the question. In terms of capital, we do expect to resume capital deployment in 2017. However, that won't be until after the pending Cigna acquisition process is completed. So, the timing and the magnitude of the capital deployment is still somewhat of an unknown.

Associated with the starting point, very clearly $10.80 we believe is the appropriate starting point. That is our guidance. That has been our expectations now for some time. And that is our 2016 -- approximately $10.80 is our 2016 guidance number. And then, of course, you have the tailwinds that offset that.

In terms of the PBM, we do not have any of the upside baked in. I think, Joe, maybe some comments just about the PBM situation in general might be helpful.

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

AJ, thanks for the question on that. As I have repeatedly stated, we are hopeful we can negotiate a settlement to our concerns, our dispute. I do not need to restate what we said repeatedly about our perspective on our contractual rights, but let me say that we do believe that we are continually focused on improving the pharmacy pricing on behalf of our customers. We expect to issue a new RFP during the year, that is early 2017 to understand the impact of various pharmacy options available to us as we migrate to the potential of a new agreement.

And I have to underscore that it is critical that we engage with a really trusted partner with aligned interests in advancing the cost-effectiveness and quality for our membership. We have not ruled anyone in or out in this process of securing an RFP. And I think with respect to any other comments made by ESI or others, we prefer not to comment on that. We do believe that a period of negotiations is still possible. And, again, I will underscore I am hopefully that we can resolve our differences moving into the future.

Operator

Matt Borsch, Goldman Sachs.

Matt Borsch - *Goldman Sachs - Analyst*

Maybe on a slightly different topic, one of your peer companies has talked in considerable length about pressure in the small group ACA-compliant book. I know you have alluded to that some. Can you just give us an update on how you see that business maybe break down in size and break down your small group between what is ACA-compliant and what is grandmothered, grandfathered, and how you see that transition happening working going into next year?

John Gallina - *Anthem Inc. - CFO*

Yes, sure, thank you for the question. Very good question. And that really is a meaningful headwind. And I think I did try to highlight it in the script. But in terms of the specificity of the question, we do not talk about a lot of this information for competitive reasons, but maybe two-thirds of our block is non-ACA-compliant today. The grandmothering expires here at the end of the year and we fully expect to be very aggressive in pursuing and renewing that block of business.

The margin aspect of it may be slightly different, slightly lower as the ACA-compliant blocks typically have a slightly lower margin compression. But we will insure that we renew it at appropriate prices and have it to be a profitable business on a go-forward basis. But we did want to spike it out as a headwind in 2017.

Operator

Kevin Fischbeck, Bank of America.

Kevin Fischbeck - *BofA Merrill Lynch - Analyst*

Two questions. First a clarification. You mentioned that, as far as the Cigna lawsuit, they're going to break it up into two pieces, and that they're going to do national accounts first. Just wondering if you had a time frame from when we would hear that? And then specifically on the Medicaid business, it sounds like Iowa should get better next year, Medicaid expansion should get worse. Are you looking for net margin improvement or margin pressure on the Medicaid business as a whole in 2017?

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

Yes, let me comment on the Cigna hearings. Beyond the December judicial process, which we are anticipating a decision sometime on or about mid December, we would expect that moving forward from there that is possible, then a trial would begin shortly thereafter, probably early January. And our hope is that would be resolved with a judicial decision by the end of January.

John Gallina - *Anthem Inc. - CFO*

And then on the Medicaid question, just to provide a little clarity, certainly Iowa is going to be a tailwind into 2017. We experienced significant upfront losses in Iowa. And even with the rebalancing of the portfolio and the retroactive rate increase, it's still, we do not believe it is actuarially sound, and the expectation is that there will be improvement in 2017.

However, associated with the remainder of the Medicaid block we are seeing some slight margin pressure. We were phenomenally successful the past couple of years with our margins, and specifically our expansion margins have been very good. And as those get repriced throughout the balance of the year they are going to be repriced at more of a target profit ratio, and that will create a bit of headwind or margin pressure for us in 2017.

Operator

Justin Lake, Wolfe Research.

Justin Lake - *Wolfe Research - Analyst*

A couple things. First, I remember back when we were going into the ACA and there were concerns around small group. You guys have put out a number of about $400 million headwind for next year, or for the coming couple of years, in terms of small group margin pressure. Is there any way for you to do something similar here? Just to give us an idea, as you go through this repricing, is there a number you can point to to say, it sounds like small group is going to be a pretty big pressure next year, as expected, maybe a little larger than we thought. Is there a way to put a number on that for us?

And then on SG&A, it has been shifting around a bit here, and wanted to get your thoughts for the fourth quarter in how we should think about this for 2017 when we add back some of these one-time benefits that you had this year.

John Gallina - *Anthem Inc. - CFO*

Sure, Justin. Great questions. In terms of the small group, we're still working through it and, really, I am hesitant to provide an answer until our planning process is done and some of the grandmothering associated with the early renewals that exist. We actually have several -- many of our small group plans renewed early on December a couple of years ago in order to maintain their non-ACA-compliant plans. I think it would probably be premature to throw a number out until we work through that process. We will update that and provide more clarity on our fourth-quarter call.

Associated with the general administrative expenses, I think maybe I will just repeat the commentary from last time. It's down quite substantially in 2016. And a little more than half of it is a good sustainable run rate, meaningful decrease in SG&A expense. It has to do with more efficient processes, better performance in some of the administrative and core areas of the Company.

And we grew into our membership. We had a really good membership year from both a membership and premium perspective, and are raising guidance on that. And we were able to do that by maintaining our administrative expense levels. Obviously then the ratio went down.

The other half, or a little less than the other half, were more one-time items, and those are nonsustainable. The most significant part of those other less than the other half is our incentive compensation plans. As we have stated, we are a pay-for-performance company. We had our promises to Wall Street and what we expected earnings to be and we ensured that we delivered those earnings and, unfortunately, we had to lower our incentive compensation expense as part of that process. So, a little less than half come back in 2017.

Operator

Michael Newshel, Evercore.

Michael Newshel - *Evercore ISI - Analyst*

Does your expectation for slight profitability in the ACA-compliant business next year assume that the national enrollment is going to be stable or growing? How would you frame the downside risk to margins if enrollment declines and the risk pool deteriorates? And, also, it looks like your relative pricing versus competitors is generally higher in 2017 than it is this year after the price hike to market exits. We saw healthcare.gov. Do you think that provides you any buffer against adverse selection next year?

John Gallina - *Anthem Inc. - CFO*

There is quite a few questions in there. Hopefully I can address all of them. I think maybe the most simple is that we expect that overall individual ACA-compliant membership on a national basis will be slightly down next year, and that our membership will reflect that.

We still have many competitors in our markets. I do want to point out that some of the exits that have been very widely publicized, very few of them impact our market specifically. Like, for instance, California still has 11 competitors, Virginia still has 8 competitors, just to rattle off a couple of our states.

In terms of the risk pool, we believe that we understand the risk pool. We're very good at the individual marketplace. We've been the number one individual market carrier for years and years prior to the ACA. Our products are designed in such a way to really get a good risk pool that allows us to maximize on risk adjusters and then be a risk adjuster collector. So, we feel good about our assumptions at this point in time.

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

Let me add that there are a few key points I think we really need to consider and keep in front. Number one, on average, our price point for targeted bronze, silver plans in the marketplace is higher than our competitors. We certainly recognize that and acknowledge it.

And while the number of competitors in our markets have declined overall versus 2016, for the most part those declines are in less populated areas, rural markets where we have had historically high market share. On the flip side there is really still substantial competition across all of our markets, those served markets, most notably in these highly dense urban markets.

And, finally, some of the largest markets did not see any significant reduction in competition. For example, California still has 11 competitors, down 1 from last year. Virginia still has 8. Georgia still has 5. So, we know we are in highly competitive markets and we believe we will compete very effectively.

But, again, I think we very effectively managed price points with respect to the products that we've offered in the marketplace. We have a fairly good outlook, as John commented earlier in his remarks, about our expected margins. And as I said, a follow on to that we will be evaluating our situation in those markets, all of our markets, through the beginning of the year to see how well we perform, and how well the regulatory adjustments play out leading up to mid year.

Operator

Lance Wilkes, Sanford Bernstein.

Lance Wilkes - *Sanford C. Bernstein & Co. - Analyst*

I just wanted to follow-up on a question with respect to self insurance margin strategy. I wanted to understand how the progress is going on specialty penetrations looking at 2017, and what your 2018 and beyond strategies were there, how much upside you saw with self insurance margins. And in particular right now with PBM, how does that fit into how you are looking at penetrations?

John Gallina - *Anthem Inc. - CFO*

Great question and certainly that is one of our growth areas for the future as we look out into our long-term outlook. We believe that the opportunity to enhance the EBITDA associated with our ASO members is meaningful. We are developing, we have ongoing efforts to drive penetration, specialty products, various ancillary type products, other add-ons that we think that we are underpenetrated right now, and believe that we have incredible amount of upside.

We have been the number one company in growing the ASO large group national membership over the last several years. And we have made quite a nice margin percentage on that business but it is very small dollars. So, now the focus is to take the fact that we do have best-in-class discounts and the most sophisticated purchasers of coverage are picking us. So, now it is our opportunity to really penetrate that better and enhance the EBITDA associated with that membership block.

Operator

Gary Taylor, JPMorgan.

Gary Taylor - *JPMorgan - Analyst*

Just a couple more questions on the individual business. First, I just wanted to follow up, I know you had just said you are anticipating exchange enrollment to decline heading into 2017. I know you also thought that would be the case heading into 2016. So, is this a rate positioning while you still believe that might play out in 2017 versus what happened this year?

And, secondly, could you just comment on any PDRs used in the individual business this quarter and your experience with the special enrollment, period enrollment this year versus last year?

John Gallina - *Anthem Inc. - CFO*

Gary, great question. 2016 was interesting because what we ended up seeing was a flight to safety, and that was one of the reasons our 2016 individual exchange membership grew more than expectations. So, if you go backwards a year and then you look at the number of co-ops who are in our markets that failed, it was a significant impact on our membership. And then as those customers then went into the marketplace, as I said, it was a flight to safety. They went for Blue.

I think the real key difference in the expectations in 2016 and the expectations in 2017 is really the amount of exits within our markets of carriers and who the exits were and how much membership those that exited had. So, long story short, the co-ops in certain markets had extremely high market share and they went insolvent and their market share was absorbed. Where, in 2017, while we certainly have some exits of carriers in our markets, they do not have the breadth or the magnitude of the market share that the ones who exited a year ago had.

Associated with the premium deficiency reserves, we have none recorded. We had none recorded in 2015. We have none recorded in 2016. It's a very easy question, which means that our results are pure, our results are clean, and that we do not have the puts and takes that maybe you have in some of the other Companies that you're modeling.

Operator

Josh Raskin, Barclays.

Josh Raskin - *Barclays Capital - Analyst*

A question, short term and a long term. Short term, I heard the commentary, I think, John, you said the results were very consistent with your expectation. And just looking at the cadence of earnings, you saw some mid to high single-digits growth in the first half, a big decline of double-digit percentage on EPS in 3Q, and now an expected increase back in 4Q. If that is all very expected, what changed this year from a seasonality perspective?

And then on the long term, from a strategic perspective, when you guys announced the Cigna deal -- and I know we are going back a year and a half now -- you talked about Cigna bringing commercial expertise and exposure to Medicare, the strong specialty, and then the international segment. So, I am curious where those priorities sit today. And in the case that the judge disagrees with you guys and the transaction does not move forward, how do you guys think about the reaction? Is there a need for scale? Is there an appetite to do other stuff? Thanks.

John Gallina - *Anthem Inc. - CFO*

Sure. Thank you. I will take the first question and turn it over to Joe for the second. Yes, I did say that our results were very consistent with expectations. When you are looking at the seasonality in 2015 to 2016, yes, 2016 is a bit challenged. The MLR is a little bit higher in the fourth quarter than it was last year.

There's a lot of variables associated with that. Clearly the Iowa variable, the individual exchange variable. Please note that we do have the G&A offset that allows us to enjoy the growth in EPS year over year.

But it is not that there is a significant change in seasonality patterns or a huge business flux as much as it was some of the very specific items that we pointed out to as headwinds for 2016 continue to be headwinds throughout the fourth quarter. I think Joe wants to address your Cigna question.

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

Yes, let me take that for a moment, Josh. First of all, to your point about, call it, pivoting in the event of an adverse decision, we are going to focus very heavily on what we talked about earlier regarding our tailwinds -- obviously in the MA growth space, very strong focus on our government business across the entire spectrum, and a variety of other initiatives that I have already mentioned.

I think it is really important to underscore that we will be coming to you at the time of that announcement, whenever. We will then share with you our outlook in terms of pivoting the Company to tackle some of those opportunities, tailwinds, as well as, quite frankly, address the headwinds as robustly as we would anyway, but certainly we believe ameliorating some of that risk would be a great opportunity to us, as well.

John Gallina - *Anthem Inc. - CFO*

I would just add to that we believe that we have long-term sustainable growth opportunities regardless if the deal closes or not. Cigna may help accelerate those. But we are very confident about our future under either scenario.

Operator

Chris Rigg, Susquehanna.

Chris Rigg - *Susquehanna Financial Group - Analyst*

John, I know you commented earlier about the dynamic of compliant versus noncompliant in the small book group. But it looks on the individual side you still have about 20% of your membership that is noncompliant. Are most of the plans for the noncompliant individuals going to remain in force until December 2017?

And then more of a macro question, do you guys have a sense for how many people have grandmothered plans in your markets at this point? Thanks.

John Gallina - *Anthem Inc. - CFO*

Yes. Great question. First of all, on the compliant versus noncompliant, the majority of those will not be noncompliant through 2017, so that the headwind/tailwind that I talked about with that, that would include both the small group and the individual commentary.

In terms of how many grandmothering are in our markets, including what our competitors have, we actually do not have specificity of that. But obviously all of the dynamics we are experiencing and the changes in the laws they are experiencing. If your question is -- is there an opportunity to get someone else's grandmothered business, the answer is really no. We would have to get it as part of an ACA compliant product.

Operator

Ralph Giacobbe, Citi.

Ralph Giacobbe - *Citigroup - Analyst*

First, just wanted to clarify the comments on the exchange again. Joe, you mentioned 2017 is a critical year and if there was no clear evidence that you would modify your strategy in 2018. Does that mean market exit or willingness to exit if you are unprofitable again in 2017?

And then also, separately, was hoping you could parse out the pressure from Iowa. I know one of your peers took a PDR in that book while you are absorbing the losses through the P&L. So, just hoping to get a sense of margins and maybe magnitude of loss this year, and what the improvement would be next year even on the inadequate rate bump.

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

Thanks. I will pivot the second part of the question to John so he can give you some of the technical aspects of it. But with respect to the first question, let me just underscore that, as I said a moment ago, we are going to be very surgical.

And let me define market. For those that define market to be state, I want to be very clear that we deal with a significant array of regions. So we will look at both regional impact as well as state impact and then make determinations with respect to what I call the surgical assessments and then decisions and execution that are necessary in order for prudent engagement in that marketplace. I believe that probably covers what you are asking.

John Gallina - *Anthem Inc. - CFO*

And then in terms of Iowa, the headwind for 2016 which becomes a tailwind for 2017 with the Medicaid block there, we did get a retroactive rate increase. Unfortunately, we think it is still not actuarially justified. We really are not providing an exact number at this point as we continue to work with the state, and don't want to get out ahead of the state and negotiate this publicly.

But just as Joe said, consistent with the individual exchange business, we need to partner with states that want to be partners. And we believe that we need actuarially justified rates. We will continue to negotiate it. We feel very good about that fact, but if we do not get it then we will have a decision to make in Iowa, as well.

Operator

Our last question comes from Peter Costa.

Peter Costa - *Wells Fargo Securities, LLC - Analyst*

Thanks for squeezing me in. Just a couple of clarifications on things you said. You said you put out an RFP for your PBM in early 2017. So, presumably that means we would see the answer sometime in mid 2017. What sort of things are you going to be looking for besides the $3 billion in savings that you already talked about? And then are you specifically coming off the $100 billion revenue target that you set out in 2014 for 2018?

John Gallina - *Anthem Inc. - CFO*

Why don't I do the second one first, Peter, while I've got the line, in terms of the headwinds, tailwinds for 2018 and Joe's commentary. It is highly unlikely that we would be able to achieve that number at this point in time. You just look at our guidance for 2016 and roll that forward and roll our membership forward. It all boils down to the exchanges.

The CBO had estimated 25 million, 26 million lives to be insured through the exchanges. When we did our 2018 plan, we relied on some of the CBO estimates as part of our estimation process. And we are still maintaining our market share, we still believe we can hit the target margins that we had for those things. But when the entire country has just over 10 million versus that other, that is a significant delta. And that goes straight into our numbers. And I think you will see that the revenue shortfall can be entirely explained with that dynamic.

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

Let me pick it up now regarding the PBM question. Yes, that RFP goes to market early 2017. I have said repeatedly that our intention is to be able to deliver to you a solution with respect to ongoing analytics, which obviously in the current state is significantly impacted by our discussions and of course potential legal proceedings with ESI.

We are hopeful to bring you a meaningful commentary and maybe solution by the end of 2017. We have never diverged from that commitment. And our hope is that we will be able to put all of the parts and pieces together to give you clarity around the decisions we are going to execute specific to the termination of the contract by 2019.

Operator

Thank you. Please go ahead with any closing remarks.

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

Again, thank you, everybody, your questions. They are always very good. As a Company, we do remain committed to tackling our healthcare system challenges head on, as evidenced by the work that we've communicated to you today. And we believe that we can and will deliver greater value to consumers by expanding access to high-quality affordable healthcare.

We have stood by that repeatedly. This is why we are committed to challenging the DOJ's recent decision to block Anthem's acquisition of Cigna in court.

Speaking to my associates, I want to also thank all of them for their continued commitment to serving our nearly 40 million members every day. To all of you on the phone, please accept our thanks for your interest in Anthem, and we look forward to speaking with you soon at upcoming conferences. Have a great day.

Operator

Thank you. And, ladies and gentlemen, this conference will be made available for replay after 11.00 AM today through November 16. You may access the AT&T executive replay system at any time by dialing 1-800-475-6701 and entering the access code 378818. International participants can dial 320-365-3844. Again, the numbers are 1-800-475-6701 and 320-365-3844 with the access code 378818.

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