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ANTM - Q1 2017 Anthem Inc Earnings Call

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OVERVIEW:

Co. reported 1Q17 operating revenues of \$22.3b and GAAP EPS of \$3.73. Expects 2017 operating revenues to be \$88-89b, GAAP EPS to be greater than \$10.37 and adjusted EPS to be greater than \$11.60.



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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Anthem First 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.

Douglas Simpson - *Anthem, Inc. - VP of IR & Finance and National Accounts*

Good morning, and welcome to Anthem's First Quarter 2017 Earnings Call. This is Doug Simpson of Investor Relations. With us this morning are Joe Swedish, Chairman, President and CEO; and John Gallina, our CFO.

Joe will provide some high-level commentary on our first quarter financial results, discuss our business unit performance and then provide some high-level commentary on our updated 2017 financial outlook. John will then discuss our key financial metric performance during the quarter and provide some additional details on our updated 2017 outlook before turning the call back over to Joe to discuss the pending Cigna acquisition and the long-term PBM solution development process. 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.



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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.

Joseph R. Swedish - Anthem, Inc. - Chairman, CEO and President

Thank you, Doug, and good morning. We're pleased to announce strong first quarter 2017 GAAP earnings per share of \$3.73 and adjusted earnings per share of \$4.68, which is ahead of our expectations with membership and revenue tracking well. It was a great quarter, and John and I look forward to discussing it with you.

I'm also going to offer my perspectives on the dynamic political landscape, premium rate calculation process we will use to file preliminary rate filings in the individual ACA-compliant business, provide you an update on the pending Cigna acquisition and provide an update on our PBM strategy.

Our first quarter results reflect business performance that track well versus our expectations. Specifically, membership grew more than expected, and we reported strong quality of earnings metrics while maintaining appropriate conservatism on our balance sheet to reflect the dynamic nature of the marketplace that exists today.

The company grew enrollment by 715,000 during the quarter, insured enrollment grew by 330,000 in the quarter, driven by growth in all of our major lines of business. As an example of the value proposition we are bringing to the market, our Local Group fully insured enrollment grew by approximately 50,000 lives during the quarter, well ahead of expectations and in a line of business that's contracting across the marketplace.

In the Individual business, enrollment increased by 222,000 lives, and we ended the quarter with nearly 1.6 million ACA-compliant members, with 1.1 million of those members on the Individual exchanges.

The remaining approximately 300,000 members are in non-ACA-compliant grandfathered or grandmothers plans, which continues to decline as expected, a decline of a little less than 100,000 since the prior year quarter.

Medicare enrollment grew by 38,000 during the quarter, primarily driven by growth in our Medicare Advantage product offerings. Our self-funded business grew by 385,000 members, in line with our expectation of 25.1 million members. This marks the fourth consecutive year of membership increases, demonstrating the value that Anthem brings to the marketplace, with our best-in-class cost of care position, coupled with highly effective medical management capabilities.

We're pleased with our first quarter results and updated outlook, and we remain focused on optimizing the performance of our assets to drive sustainable growth. We recognize many opportunities across our business as our industry continues to face disruption on multiple fronts.

In response to this dynamic external environment, I believe it is critical to improve our speed to market, corporate agility and overall performance. I've challenged our leadership to take a hard look at our business operations and culture to optimize sustained value creation for all of our stakeholders. Anthem is in a position of strength, with a diverse portfolio of outstanding assets and a dedicated team of leaders and associates.

This strategy reinforces our confidence in improving our long-term earnings growth rates toward the upper single digit to lower double digit range beyond 2017, as we discussed in our last earnings call.

We are continually balancing our near-term results with our longer-term strategy. I look forward to updating you on our progress in the future.

Our strong first quarter financial performance reflected contributions from both Government and Commercial businesses.



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In the Government Business, we added 70,000 members during the quarter, reflecting growth of 38,000 in our Medicare business; 29,000 in Medicaid; and 3,000 in the Federal Employee Program.

The enrollment growth, coupled with rate increases, translated into first quarter 2017 Government Business operating revenue of \$12 billion or growth of 11.4% versus first quarter of 2016.

Operating margins for the Government Business were 2.6% during the first quarter of 2017, a decline of 40 basis points compared to the prior year quarter.

The expected decline was primarily due to the impact of the 1-year waiver in the health insurance tax in 2017, which, as you know, is not tax-deductible.

During the quarter, we recognized retroactive revenue related to the Iowa Medicaid contract. This adjustment has been agreed upon with the state, partially cover the significantly higher-than-expected claims cost experienced since April 2016.

While the additional revenue enhanced our first quarter performance, our initial outlook expected the improved Iowa rates to take effect with the July 1 rates. Therefore, the benefit of this adjustment has not yet been incorporated in our updated 2017 outlook. We will continue to work collaboratively with our state partner and make progress with the understanding that we need to receive actuarially justified rates in the rate renewal process. We remain confident we will meaningfully impact Iowa's citizens by improving the cost and quality of care as we have done for other state partners.

Aside from the additional revenue recognized in Iowa, our first quarter performance was in line with expectations in the Medicaid business.

The current Medicaid pipeline continues to be robust. We're implementing new business in Virginia and Texas that should go live later in 2017. In addition, there are 6 active RFPs, of which we expect to hear about over the next couple of months, with those awards expected to be implemented in 2018.

Looking out over the horizon, we are monitoring an additional 15 to 20 RFPs that we expect to be released over the next 1.5 years, which will include both opportunities for additional business in new and existing states and existing contract reprocurments, which in many cases, will offer the potential for additional opportunities in our current contracts.

Within Medicare, we are pleased that enrollment growth of 38,000 during the quarter exceeded our expectations, primarily in our Medicare Advantage product offerings, as we now have over 50% of our membership residing in 4-star plans.

We continue to expect to grow MA enrollment by low- to mid-double-digit percentages in 2017, and perform within our targeted operating margin range.

Switching to our Commercial business, as I discussed earlier, our enrollment came in better than expected, growing by 645,000 members during the first quarter of 2017 to 31 million members. This growth translated into better-than-expected operating revenue, totaling \$10.3 billion in the first quarter of 2017, an increase of nearly \$800 million or 8.2% versus the first quarter of 2016. The strong enrollment gains were across the entire segment, with better-than-expected growth in the Local Group business, fully insured and self-funded product offerings.

The Commercial team has been focused on identifying opportunities to mitigate the fully insured enrollment trends experienced over the last few years, and we are pleased that these strategies are proving to be effective in the market.

First quarter 2017 operating margins of 12.7% declined by 90 basis points from the 13.6% in the first quarter 2016. This decline was due to the impact of the Penn Treaty assessments that were recorded during the quarter, and the first year waiver of the health insurance tax in 2017. Partially offsetting the margin decline was the benefit of 1 less calendar day during the quarter, as first quarter 2016 was a leap year, a lower SG&A ratio due to expense efficiency initiatives and fixed cost leverage from growing operating revenue.

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We continue to target improved penetration rates in our specialty product offering, and we're very pleased that our efforts are taking hold in the marketplace. Our dental membership increased by 373,000 or 6.8% during the quarter, and vision membership increased by 405,000 or 6.3% during the quarter.

While we still have additional opportunities to continue to increase penetration rates for the various ancillary specialty product offerings, I'm encouraged with the momentum this business has generated as we continue to improve the value of the products we bring to the market and align incentives appropriately within the distribution channel.

In the individual ACA-compliant business, we are all pleased with the membership growth in the open enrollment period, with claims experienced in the first quarter coming in better than prior year, which is reflected in our improved medical loss ratio.

However, the claims experienced during the quarter was slightly higher than we anticipated, and we're closely monitoring and analyzing the morbidity of our membership. Given a little under 50% of the population is new to Anthem, we're also not yet able to determine the morbidity of the entire marketplace, which would have implications for the risk-adjustor calculation. We should have a more thorough understanding in Q2 of our expectations for full year 2017 financial performance.

Reflecting on these dynamics and recognizing the level of volatility in the individual ACA-compliant product offerings, we are assessing our market footprint in 2018 as well as rate increases necessary to reflect the underlying morbidity and expected costs of this population.

Our financial expectations vary by market and some markets are expected to be operating on a sustainable basis. We will continue to focus on participating in only those markets, which are in a visible path towards sustainability, including factors like the expected financial performance, regulatory environment and underlying market characteristic.

We are pleased that some steps had been taken to address the sustainability of the market, such as addressing the risk adjustment formula in 2018 and verification of eligibility requirements for special enrollment period members on the federal exchanges.

We are pleased to see the final market stabilization regulation and anticipate that it will have a long-term positive impact. These changes should help improve stability, but there's still significant uncertainty around some key funding components.

For example, we do not yet have certainty that funding of the cost sharing reduction subsidies will be continued. Additionally, under current law, the health insurance tax will be reinstated in 2018, negatively impacting the affordability of fully insured products, including Medicaid and Medicare.

It's estimated that before accounting for any other issues, rates could increase by an additional 20% or more if CSR subsidies are not funded. The return of the health insurance tax is also expected to increase rates by an additional 3% to 5%. Obviously, this level of additional increase would cause further market instability to a level at which it would be even more challenging to appropriately estimate actuarially sound rates.

At this point, we plan to file preliminary 2018 rates, with the assumption that the cost sharing reduction subsidies will be funded. However, we are notifying our states that if we do not have certainty that CSRs will be funded for 2018 by early June, we will need to evaluate appropriate adjustments to our filing.

Such adjustments could include reducing service area participation, requesting additional rate increases, eliminating certain product offerings or exiting certain individual ACA-compliant market altogether.

Funding CSRs in 2018 and eliminating the health insurance tax going forward are only some of the steps necessary to ensure that the individual ACA-compliant marketplace is not further destabilized. We believe that additional funding and programs, such as high-risk pools and reinsurance should be done to help improve the stability of the marketplace, and we continue to work with the administration and members of Congress on these issues.



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As we stated in our fourth quarter call, we are monitoring developments closely in the first half of 2017 as we evaluate our longer-term strategy in the Individual marketplace. We are analyzing the impact of regulatory changes, along with updating our expectations of underlying cost trends, while we continue to advocate for additional regulatory adjustments to ensure both a stable and sustainable Individual market.

We expect to provide additional clarity on our 2018 market footprint during our second quarter earnings call, if not sooner.

Turning to discuss our updated 2017 financial outlook, we now expect adjusted earnings per share greater than \$11.60 for the full year 2017, an increase of \$0.10 from our previous outlook. I believe our updated outlook is prudent, given the uncertain nature of the individual ACA-compliant marketplace.

With that, I'll turn the call over to John to discuss our financial statements and provide additional details on our updated 2017 outlook. John?

John E. Gallina - Anthem, Inc. - CFO and EVP

Thank you, Joe, and good morning. I'll begin by discussing the consolidated financial highlights during the first quarter.

On a GAAP basis, we reported earnings per share of \$3.73 in the first quarter of 2017. These results included net negative items of \$0.95 per share. Excluding these items, our adjusted EPS is \$4.68 for the quarter. These results were favorable to our expectations and as Joe noted, we are pleased with our strong start in 2017.

As highlighted earlier, our membership results in the first quarter were strong and translated into better-than-expected operating revenues, totaling \$22.3 billion. This represents an increase of \$2 billion or 9.9% versus the first quarter of 2016.

The increase in revenue was a result of premium rate increases cover overall cost trends across all lines of business and higher enrollment in Medicaid, Medicare and Local Group, fully insured and self-funded businesses. These increases were partially offset by the impact of the 1-year waiver of the health insurance tax in 2017, which allowed us to decrease premiums for this component as part of our efforts to address affordability.

The benefit expense ratio is 83.7% in the first quarter of 2017, an increase of 190 basis points from the prior year quarter. This expected increase was driven by the impact of the 1-year waiver in the health insurance tax. As expected, the rate pressures in medical cost experienced in Medicaid is contributing to the increase.

The Iowa contract, which was not effective until April 1, 2016, is the primary driver of our year-over-year increase in the medical loss ratio. These increases were partially offset by the impact of 1 less calendar day in 2017 as the first quarter of 2016 was a leap year. And the net impact of premium rate increases in the Individual business, particularly within our individual ACA-compliant product offerings and the impact of a retro revenue adjustment in the Iowa Medicaid contract recorded during the quarter.

Our first quarter 2017 SG&A expense ratio of 14.3% came in higher than expected due to a nonrecurring assessment recorded due to the Penn Treaty insolvency, but it still declined by 150 basis points from 15.8% in the first quarter of 2016.

The decrease was primarily driven by the impact of the 1-year waiver of the health insurance tax and from lower administrative costs, which resulted from expense efficiency initiatives, coupled with fixed cost leverage on our strong membership growth.

These decreases were partially offset by the Penn Treaty assessments that were recorded during the quarter, which are included in SG&A expenses, but excluded from our adjusted earnings per share calculation.

Turning to the balance sheet, we have included a roll forward of our medical claims payable balance in this morning's press release. For the first quarter 2017, we experienced favorable prior year reserve development of \$795 million, which was moderately better than our expectations.



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Our reserves continue to include a provision for adverse deviation in the mid to high single digits, and we believe our reserve balances remain consistent and strong as of March 31, 2017.

Our Days in Claims Payable was 40.6 days as of March 31, a decrease of 0.7 days in the 41.3 days we reported at the end of 2016. The decline was expected and is primarily due to the faster claims payment speeds as we continued to migrate membership on the faster payment platform, primarily within the Government Business.

Our debt to cap ratio was 39.7% as of March 31, 2017, an increase of 120 basis points from the 38.5% at the end of 2016, which reflects the impact of an increase in commercial paper borrowings, partially offset by an increase in shareholder equity and a repayment of a \$400 million note that was due in mid-February.

During the first quarter of 2017, the company repurchased approximately 300,000 shares of its common stock to \$51 million at a weighted average price of \$160.81. As of March 31, 2017, the company had approximately \$4.1 billion of board approved share repurchase authorization remaining.

We ended the first quarter with approximately \$4.2 billion of cash and investments at the parent company, and our investment portfolio was in an unrealized gain position of approximately \$687 million at the end of the quarter.

For the 3Rs, consistent with our strategy, we are in a significant net receivable position for risk adjusters for both the 2016 and 2017 benefit year, we have refined our insurance estimates and are expecting the pool to payout at the 50% coinsurance rate.

And finally, on risk corridors, we continue to record a 100% valuation allowance for all unpaid receivables for the 2014, the 2015 and the 2016 benefit years.

Now moving to cash flow, for the first quarter 2017, we reported operating cash flow of approximately \$2.7 billion or 2.7x net income, which was stronger than expected. Cash flow in the quarter included the impact of collecting an extra CMS Medicare payment and also the fact that we did not make an estimated federal tax payment.

As a reminder, we will make 2 estimated tax payments to the federal government in the second quarter. Even after adjusting for these items, operating cash flow was still strong, reflecting the quality of our first quarter earnings.

We used \$172 million during the quarter for our cash dividend, and we declared a second quarter dividend of \$0.65 per share.

Turning to our financial outlook, we increased our operating revenue guidance for 2017 by \$1.5 billion to a range of \$88 billion to \$89 billion. This increase reflects higher projected membership due to the strong enrollment results seen through the first quarter as we have discussed.

Fully insured membership is now expected to be in the range of 15.2 million to 15.3 million or 100,000 higher than our previous outlook, which reflects stronger-than-expected growth in both the Individual and Local Group insured businesses.

Self-funded membership is still expected to be in the range of 25 million to 25.1 million as better-than-expected results in our large group self-funded business is largely offset by slower than expected growth in BlueCard enrollment. Taken together, we now project a total membership to be nearly 300,000 and 500,000 lives higher than at the end of 2016.

We continue to expect our 2016 medical loss ratio to be 87%, plus or minus 30 basis points, and now expect our SG&A ratio to be at 13.6%, plus or minus 30 basis points on a GAAP basis, which includes the impact of the Penn Treaty assessments and the CIGNA-related transaction cost incurred during the first quarter of 2017. We continue to expect 2017 Local Group medical cost trends to be in the range of 6.5% to 7%.

We are encouraged by our first quarter operating cash flow, and we continue to project operating cash flows to be greater than \$3.5 billion in 2017, excluding the potential cash payments related to the Penn Treaty assessments during the year.



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Regarding capital deployment, our 2017 outlook continues to include the benefit from \$1.5 billion to \$2 billion in share repurchases through the remainder of the year.

To conclude, our 2017 earnings per share outlook is greater than \$10.37 on a GAAP basis, which increases our adjusted earnings per share outlook to greater than \$11.60.

We believe our outlook is appropriately prudent given the uncertainty in the individual ACA-compliant marketplace and the expected year-over-year margin compression in the Medicaid business, particularly within the expansion population.

It is important to note that our outlook does not include any additional benefits or transaction costs associated with the pending acquisition of Cigna beyond those incurred in the first quarter of 2017.

Our outlook also does not include any benefit from lower pharmaceutical pricing, which we continue to believe we are entitled to under our current contract with ESI.

With that, I'll turn the call back over to Joe to discuss the pending Cigna acquisition and an update on our PBM strategy. Joe?

Joseph R. Swedish - Anthem, Inc. - Chairman, CEO and President

Thanks, John. Relating to the pending Cigna acquisition, we continue to work through the expedited appeal process through the court system. We participated in oral arguments at the end of March and expect to hear a decision from the appellate court relatively soon.

Concurrently, we were also granted our motion for a temporary restraining order to enjoin Cigna from terminating the merger agreement. The next hearing on this motion is scheduled to be held on May 8 in the Delaware Court. We remain committed to completing that acquisition as soon as possible.

Turning to discuss the process of forming our long-term pharmacy strategy, we did issue the RFP during the first quarter and we expect to receive all responses during the first half of the year. It is important to note that we have not ruled anyone in or out as the best strategic option for the company going forward.

After we received the responses to the RFP, our pharmacy team will thoroughly and thoughtfully analyze what has been proposed in order to decide how to construct the best pharmacy solution for our members.

As I previously stated, this process will be completed by the end of 2017, and we have committed to informing the market of our strategy by that time. We continue to believe that we will be able to lower our pharmaceutical cost by more than \$3 billion annually in 2020 and beyond.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Christine Arnold from Cowen.



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Christine Mary Arnold - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Let's start with Individual. How did Individual develop relative to your mid-single-digit range? And given that we don't know how the risk adjusters going to look because we don't have the data and you're our last man standing in a couple of markets, how did your risk adjuster accrual look versus a year ago?

John E. Gallina - *Anthem, Inc. - CFO and EVP*

Thank you, Christine, be happy to respond to that question. In terms of Individual -- not positive what you mean by mid-single-digit range, if that's the long-term aspirations in terms of profitability, we did state 90 days ago that we expected our 2017 Individual block business to be essentially a breakeven, maybe a little bit better. So those are the expectations that we've had for the year this entire time. In terms of risk adjusters, we are a risk adjuster receiver. We have -- really have designed our products and had our entire strategy around collecting receivables associated with risk adjusters. In the areas where we were the last man standing, we went back to the various states and changed our rating formulas associated with that to get additional rates in 2017 associated with those. So all in all, the Individual business started out 2017 significantly better than it started out 2016. However, a little bit behind our expectations, we've been very cautious in terms of recording any incremental risk adjusters in '17 versus what we believe we are entitled to, from our strategic standpoint. So to the extent that our morbidity is a little bit worse than the entire pool, we have upside associated with our expectations. If our morbidity is consistent with the overall pool, then our expectations, I think, are very prudently and appropriately stated. But at the end of the day, we do expect to be a significant risk adjuster receiver.

Joseph R. Swedish - *Anthem, Inc. - Chairman, CEO and President*

John, I might add also that you just pointed out my claims for the quarter being a little in excess of our forecast, and our sense is that, as you would expect, 1 quarter doesn't make a year trend and we're going to be monitoring this very carefully, given the fact that we've got a member mix that's -- we still have to analyze very carefully. And our sense is that a lot would be known to become clear as we get into the second quarter, leading up to the end of June, and then we'll be able to obviously, report more details to you in the next earnings call.

Operator

Your next question comes from the line of Chris Rigg from Deutsche Bank.

Christian Douglas Rigg - *Deutsche Bank AG, Research Division - Research Analyst*

I guess you've spoken a lot about the Medicaid impact in the Government segment business, but I was hoping, given the growth in Medicare, if you could give us a sense for how that side of the business is trending.

John E. Gallina - *Anthem, Inc. - CFO and EVP*

Yes, sure, Chris. Thank you for asking that question. We grew our Medicare Advantage by about 38,000 members in the quarter, which is consistent with our expectations. As Joe had mentioned, that we have over 50% of our membership in 4-star plans. We think we're very well positioned for future growth. We are -- we're projecting to grow that membership in the double-digit range. The marketplace that we operate in has a market average growth rate of 6% - 9% per year over the next several years, and we're looking at a low double digit growth rate in that area. We obviously have the [agents] that we'll get a fair share of over the rest of the year. And our operating margins right now are very much in line with our target margins associated with this line of business. So we actually think that we're very well positioned and feel very good about our start of the year in the Medicare arena.

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Operator

Your next question comes from the line of AJ Rice from UBS.

Albert J. Rice - *UBS Investment Bank, Research Division - MD and Equity Research Analyst, Healthcare Facilities*

I'm just going to follow up a little bit more on your comments, Joe, around your PBM contract, if I could. Obviously, there seems to be a little bit of a divergence between what you're communicating today and what was released by your current PBM earlier in the week. I wonder if there's any way to reconcile that? And another aspect of this discussion is they put on the table \$1 billion in each of the next 3 years plus "market rates" after that. Can we assume that, if you're not taking that, you think you can do better than that? And then finally, on this issue, is there any update on the status of the litigation, and what is happening with that? Are there any dates upcoming on the litigation with the PBM?

Joseph R. Swedish - *Anthem, Inc. - Chairman, CEO and President*

AJ let me take your question in the following order, dealing with so-called reconciliation regarding what was said by ESI, the \$1 billion offer and then the litigation outlook. With respect to reconciling statements, quite frankly, that's not easy, if possible, quite frankly, because they certainly have made statements that support their perspective. We made our position very clear. We've been steady with respect to our expectations, beginning with our first declaration back in January of '16, and I can underscore that we really have not changed our position, with respect to our expectations around a \$3 billion opportunity for us to recover costs that we believe we are due, relative to both our contract as well as go forward for 2020 and beyond. So I can't speak and won't speak on behalf of ESI and their perspective, other than continually refer everyone back to what we've repeatedly said and obviously, we continue to stand by our statements. I do want to underscore and I've said this repeatedly as well, that we are hopeful that we can resolve our dispute, with respect to our interpretation of the agreement as well as our expectations with respect to supporting our cost structure in a more positive manner and how that then translates for our customers. And however, we certainly are coming upon some very critical due dates. As I stated a moment ago, we have issued RFPs. We have stated that on an earlier call. We have followed through with issuing an RFP to many, many respondents. We expect to receive all the final details by the end of the first half of the year. And then, we'll go to the analytical phase, and then as I've said repeatedly, we will report to you in Q4 our decision, with respect to how we plan on proceeding, with respect to executing on our PBM strategy, 1/1/20 and beyond. With respect to litigation, we are currently in discovery phase. That's really kind of the -- let's call it sum and substance of what I can report at the moment. We are expecting to complete discovery sometime after midyear. That could be pushed back as you would expect in litigation proceedings. So I would ask you to stay tuned in that regard once the discovery is finished, and I think, some critical dates in terms of timing on various matters related to the litigation to become clear. I do want to underscore that we are very excited by the opportunity to put together a new solution that serves our members better than our current situation. Our team has been focused heavily on identifying the right solution for the long term. We've talked about some possibilities in and around state of course under a new arrangement, going in a different direction, with respect to vendor support, crafting a hybrid model. We have stated all of that publicly, and we're still very focused on crafting the absolute best solution, to best serve our customers. So we believe we have all the ingredients to keep marching forward, and to give you the answers that we always declare we would give you by Q4. So AJ, I hope I covered up everything you wanted me to touch on. There may be other questions from others, but I think, in the main, I think, I've covered all the critical aspects of where we are at the moment.

Operator

Your next question comes from the line of Justin Lake from Wolfe Research.

Justin Lake - *Wolfe Research, LLC - MD and Senior Healthcare Services Analyst*

First, just let me just follow-up on the PBM. Joe, you mentioned you haven't ruled anybody out. Does that mean that ESRX has gotten a copy of this RFP and is participating? And then can you talk about the hybrid model that you mentioned here, in terms of what that means? And is that a reason why that even though Express may or may not be offering you interesting economics here in the short term to renew, you're looking to go on a completely different direction and therefore, the \$1 billion isn't a year settlement to your -- to extend wouldn't be interesting to you? And can



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you just verify whether you feel that they have put that offer on the paper on the first place? I apologize for the follow-up, but I think, people are pretty interested.

Joseph R. Swedish - Anthem, Inc. - Chairman, CEO and President

No, it's all one big ball of yarn and I certainly understand how you kind of packaged it together. No problem at all. I can respond and must respond, as you would expect, and I don't want to comment on any specific vendor and their engagement with respect to the RFP process, where they've chosen to participate or not participate or how the final submittals will look. So again, I don't want to kind of comment on who got what. So with respect to decisions, obviously, we've not made a final decision with respect to any vendor, and I've stated that clearly, that we've not done so and we've not ruled anyone in or out. I think that covers the entire spectrum of vendor possibilities. And I'll leave it at that. With respect to the \$1 billion statement, again, that statement that came from ESI, I really don't want to and can't obviously, for many, many reasons, talk about negotiation discussions. And I'd just come back to the point that's repeatedly said, we're hoping for an amicable resolution to our current litigation. What that might mean, with respect to engagement in our PBM strategy execution going forward remains to be seen. But my sense is that we've got a lot of possibilities as we use the word repeatedly, I think I can underscore here and answer your question yet again, and that's optionality. Optionality has been a watchword for us, and I can use the word hybrid, because hybrid means kind of a mixture of possibilities around formula management, mail order and those kinds of things in terms of how you manage it may look remarkably different than constructing a contract that may be as old as 5, 6, 7, 8 years. The world has changed in this space and we're certainly going to take advantage of the absolute best performance possibilities to serve our customers. I must again underscore that there has been no change to our \$3 billion annual expectation for lower pharmacy costs. We are resolute on that point. We believe we've done enough analytics around market checks that we believe it's a very credible expectation, and we are holding firm on how we believe we're going to be looking at our performance for the balance and the term of the agreement as well as 1/1/20 and beyond.

Operator

Your next question comes from the line of Ana Gupte from Leerink.

Ana Gupte - Leerink Partners LLC, Research Division - MD, Healthcare Services and Senior Research Analyst

So I'm just trying to follow up on your guidance and the puts and takes, so I'd make sure I understood this. And you feel by a significant amount, I would assume you knew about the leap day (inaudible) when you've guided, but your raise is \$0.10. For exchanges, it's about, I guess, a little under \$0.10 for every 100 basis points on margins, give or take. And I'm trying to understand how much conservatism or what margins are you seeing right now, especially in -- how much potential deterioration might you expect going forward? Or is this mostly about the risk-adjustor payment coming in less than you expect?

John E. Gallina - Anthem, Inc. - CFO and EVP

Sure, Ana. Thank you for the question. First of all, just to clarify, leap year does not influence our 2017 outlook. Leap year was a dynamic of 2016 that caused the first quarter of 2016 to be less profitable than it would have been on a seasonality basis. So then when you compare the seasonality of the 2016 results for the first quarter versus our first quarter of 2017, of course, our seasonality would enhance our first quarter profitability in 2017. But for the full year, it's not relevant. In terms of the guidance, as we said, we're trying to be very prudent. I just want to be clear that the Individual business is doing markedly better than it did last year. A lot of the information is consistent with expectations, with claims activity were a little bit higher, to the point that, as we are looking at the morbidity of the membership, it's really too early to know will our risk adjuster position be enhanced or not. And we've taken the conservative outlook that our risk adjuster position will not be enhanced. If it is enhanced, we have upside. And so we believe that we are being appropriately prudent here with our expectations for 2017 because it is so early in the year. Very clearly, we'll have a lot more information on the second quarter.



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Operator

Your next question comes from the line of Ralph Giacobbe from Citi.

Ralph Giacobbe - *Citigroup Inc, Research Division - Director*

I want to ask on the Commercial risk business. Sounds like enrollment is tracking ahead of expectation and that's been a business that's seen some pressure and you mentioned strategies around that, I guess I just want to understand that a little bit more. And then how much is it sort of market share gains or are you seeing any shift from ASO to risk?

John E. Gallina - *Anthem, Inc. - CFO and EVP*

Great question, Ralph. We are very pleased with the growth that we've seen in Commercial fully insured group business and are very happy with that. So it's been several things, we really went to the market with improved product designs that were received very well by the marketplace. In terms of really focused on price points, as you know, we've gone through several years of really fine-tuning our administrative costs and have really done a great job of growing membership and getting great fixed cost leveraging associated with that, and allowed some of those savings to go through in terms of more attractive price points to the membership. We are obviously ensuring we offer a competitive product, and given the leading provider relationships we have and the medical management we have and quite honestly, the #1 cost of care position we have in our marketplace, we've got a great product. And are really very well positioned from a competitive marketplace. In terms of what's going on with the overall market, and is it groups going from ASO to fully insured or are we increasing share, it's really -- it has a lot to do with capitalizing on a shrinking marketplace. Joe, did you have a few other comments you want to add?

Joseph R. Swedish - *Anthem, Inc. - Chairman, CEO and President*

Yes, it's a great question related to our engagement in the market with our provider community. I really don't want to let the moment to go by without calling out the tremendous success in and around provider collaboration. As you know, that's been a -- I'd call it a hallmark of the company now for a few years and the pillar regarding our success going forward. You used term value and when I speak or think about value, I'm thinking about our provider collaboration engagements, such as 159 ACOs in our markets, we've got over 64,000 providers now engaged in ACOs, and patient center medical homes who are accountable for cost of quality of care for 5.5 million -- over 5.5 million Commercial members, which is a huge uptick compared to prior years. It's interesting to underscore also that aggregate spend regarding value-based contracts tally up to about 58% of our total medical spend across all lines of business, and over 75% represented by shared savings agreements, shared risk arrangements, population-based payment models. And then we've got sort of the remainder of that spread between 75% and 100% of 58%, is in various pay-for-performance arrangement. So we're really pleased with those kinds of stats. I think it really speaks volumes regarding our shift value-based payment models and partnership with our provider community whether it's small group, practitioners, large-scale organizations like Aurora Health Care in Wisconsin, there are many, many other groups that we've aligned with, with respect to our product offerings and markets that are now delivered in tandem with our provider community. So again, I'm very proud of that performance and I really want to call it out, because I think, again, it's a hallmark of the company's performance in all the markets we're serving.

Operator

Your next question comes from the line of Gary Taylor from JPMorgan.

Gary Paul Taylor - *JP Morgan Chase & Co, Research Division - Analyst*

Just a 2-part question, I just want to go back to guidance for a second, maybe come at it just a little bit different way. In the first quarter, earnings were up \$1.22, and I know obviously, leap year is a part of that. But for the full year, your guidance is that earnings are only up \$0.60. So it implies that combined earnings over the next 3 quarters are actually down and, given the increased seasonality, maybe that might be true, the -- of the



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fourth quarter. But just kind of wondering why that much conservatism in the remainder of the year. Is that still just primarily related to exchanges? And then the second part is if -- if your -- be great if you could size the retro lowa, but also -- I didn't quite understand the comment on why the lowa rate increase wasn't yet in the guidance.

John E. Gallina - *Anthem, Inc. - CFO and EVP*

Yes, sure, Gary. And actually, there's questions I think can all be answered simultaneously. I appreciate the 2-part question. In terms of the first quarter and how you've calculated it, a couple of other things do need to be taken into consideration versus the expectations in your analysis. Number one, we did have a change in the treatment of the taxes associated with stock-based compensation that we implemented in the first quarter of 2017, so that was certainly additive as a onetime catch-up or true-up associated with adopting that accounting principle. And then, the second part, it is the retro lowa true-up. We really cannot go into a specific dollar amount associated with it, other than to say that, that retro payment was reimbursement for a portion of the losses that we experienced in 2016 under that contract. We continue to work with the state to obtain actuarially justified rates as of July 1. As those negotiations are ongoing, it really would be premature and inappropriate to comment on them publicly other than to say that we want to be very cautious in terms of what we're including in our outlook associated with the overall situation there. So we've, again, tried to be very prudent in terms of how we're looking at that. And as you look at the metrics that you rattled off, we have a prudent-approached Individual. We have a continued margin pressure in our Medicaid expansion business that we've been signaling for quite some time. It's actually very much in line with expectations, but it is a real issue. And then the seasonality of leap year, I think, are all significant metrics that need to be taken into consideration when you do the math that you did.

Operator

Your next question comes from the line of Mike Newshel from Evercore ISI.

Michael Anthony Newshel - *Evercore ISI, Research Division - Associate*

So my question is on the remaining timeline and legal strategy around the Cigna transaction. So first, if you lose the appeals decision, is that the definitive end? Or is there any last minute hope for a DOJ settlement? And if you do win the appeal, if you're still waiting on the court, when you get to that May 8 hearing, is it your intention to ask the judge to keep the injunction in place to hold Cigna to the agreement beyond the April 30 expiration?

Joseph R. Swedish - *Anthem, Inc. - Chairman, CEO and President*

Yes, thank you very much for the question. Obviously, like you, we're kind of trying to evaluate our options depending on which way the court goes, which we believe the decision is relatively imminent, with respect to the appeals court, and to underscore what you said, the Delaware chancery will be convening on May 8, so there are still a lot of judicial proceedings to occur. In assessing that, we believe the appeals court and probably I'm telling something that you already know, but there are probably about 3 directions that it can go in, which would be to just categorically deny our appeal across the board; another would be to accept it but, in part, remand some of it back to the district court; and then the final one, obviously, would be to accept our appeal in its entirety and have us move forward. So each one of those requires very significant discernment on the choices that we have. And probably leave any further commentary regarding our choices to another time when it becomes clear what the court's decision is. So I really don't want to speak exactly to what we can or can't do relative to each one of those decisions. Regarding the chancery court, obviously, how it evaluates situation is dependent on the appeals outcome. And so I guess, long story short, we're going to have to judge our go-forward position based on the decision by the appeals court. And then, obviously, make the best choice possible for us. But I do want to underscore that we are continually committed to the acquisition both with respect to the board and management, and we are proceeding with all the effort necessary to come to a reasonably good outcome regarding our commitment through the acquisition.



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Operator

Your next question comes from the line of Josh Raskin from Barclays.

Joshua Richard Raskin - Barclays PLC, Research Division - MD and Senior Research Analyst

Just 2 clarifications, first, as I make sure I understood on Iowa, are you including a rate increase for July 1 in the guidance? And then the second question was, I think I heard Joe talk a little bit the long-term EPS growth rate of that high single digit to low double digit. Did I hear sort of a change towards the higher end? Is that something you're more comfortable with now? Are you guys sort of shifting your thoughts on long-term EPS growth?

Joseph R. Swedish - Anthem, Inc. - Chairman, CEO and President

This is Joe. I'll respond just very quickly. No, you didn't hear anything that's any different than the first comment we made with respect to high single digit, low double digit expectations. So John, you want to take it away?

John E. Gallina - Anthem, Inc. - CFO and EVP

Yes, sure. So the first part of your question, Josh, was on Iowa. And our plan has all along been to receive actuarially justified rate increases as of July 1. We still believe we're entitled to those, and we're working very closely with the state in order to achieve those. However, as I commented, the first quarter of '17 benefited from this onetime retro premium adjustment. We are very cautious to include it and a full actuarially justified rate increase on July 1 in our guidance or in our outlook, we believe we're entitled to it, but until we have more clarity, we don't want to get out ahead of the negotiations. So but our original expectations all along have been July 1 actuarially sound rates.

Joseph R. Swedish - Anthem, Inc. - Chairman, CEO and President

John, I probably need to add some commentary to the question about high single digit, low double digit expectation of long-term growth. We do have strategies that we are targeting and I think, it really is important to underscore that those strategies are targeted at Government Business as you know, with respect to both Medicaid, Medicare. We've talked liberally about our Medicare outlook, particularly in terms of organic growth and combined with M&A opportunity. Our Commercial business has a lot of targeted opportunities, particularly in the area of increased wallet share in and around specialty offerings to the market. And then, membership gains in a variety of places, our SG&A expense controls we believe will be a key contributor, with respect to the operational improvements we believe were possible as we better adapt to the marketplace and also be able to effectively leverage our growth in membership based on a very prudent and highly efficient application of our expenses. And then finally, and I'll let John speak to this, with respect to capital deployment choices that we have ahead of us. I can't leave out the PBM repricing process as well. So in any event, we've got a very significant combined effort, a variety of opportunities that we think will take us to point of meeting the expectations that I stated last call, as well as this call. I don't know, John, if you want to add anything.

John E. Gallina - Anthem, Inc. - CFO and EVP

Yes, no. Thank you, Joe. And yes, on the capital allocation, that clearly -- the capital planning structure, that clearly was part of our high single to low double digit thought process as we go through and evaluate future M&A opportunity, share buyback opportunities, other ways to return capital to shareholders through dividends, getting an appropriate balance for all those things we think are critically important. And I'll just -- I just want to reemphasize, when we say high single to low double, that is a long-term view over many, many years. And obviously, some years it can be at the lower end and some years it can be at the higher end. So any 1 year is not indicative of what a long-term multiyear view might be, and that we are very comfortable given our strategy, given our track record and given our growth prospects that we can achieve high single to low double on average over a multiyear period.



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Joseph R. Swedish - Anthem, Inc. - Chairman, CEO and President

I think, John, just reinforce something I said at the very beginning of my commentary and that is internally, we are looking very carefully at our operational performance, trying to understand the transformative responsibilities we have to better manage the company in terms of supporting our business model and in particular now as you've just heard, related to these strategic initiatives that we have targeted. It's not just about the pieces of the puzzle we just described but also how we then support each part of that puzzle being accomplished with respect to our go forward to success that we envision. So a lot of internal shifts and changes with respect to better performing in support of our strategic commitment.

Operator

And your final question today comes from the line of Peter Costa from Wells Fargo.

Peter Heinz Costa - Wells Fargo Securities, LLC, Research Division - MD and Senior Analyst

And I hate to end it in going back to the PBM, but I just want to try to continue to reconcile the differences in your statements and ESI's. You've talked about needing to get that \$3 billion or believing you are owed the \$3 billion in annual savings, Express has shared some numbers and suggested that they can't give you \$3 billion in incremental savings. So is that really what's causing the difference in terms of their view of what you've said to them and your view of saying it's open to everybody? Is it really only open to everybody, to the extent you get \$3 billion in savings?

Joseph R. Swedish - Anthem, Inc. - Chairman, CEO and President

Well, appreciate you bringing it back to the table. And hope you can appreciate my comeback, which I've repeatedly stated, which is we stand by our \$3 billion expectation, and quite frankly we believe that's at a minimum \$3 billion based on the analytics, the market check performance that we've administered now over quite a lengthy period of time. And so our outlook at 1/1/20 and beyond is very much guided by that reality. And as such, obviously, we are driven by our focus on creating value for our members and our shareholders. You may recall, what we said repeatedly is that about 20% of that pickup and improvement is going to flow to the shareholders, conversely it's going to be 80% going to our members. So it's a huge [nut] that we believe needs to be correct and for the benefit of so many. And I understand your question, with respect to the billion, but again that's their number and I really don't want to comment on their analytics, why they believe, what they believe. I know that all of you are very focused on applying the math, but their numbers, you do our numbers and I'll just have to leave it at that, let them speak for themselves and I certainly respect where they're coming from, but obviously, we have a different point of view, and we believe it's a point of view that's validated by the statistics that have flowed out of our analytics. And so we stand by our position and the negotiating process with respect to the litigation we are in, I really don't want to comment on that either, because there are some sanctity related to the litigation process through discovery and beyond and I think, the prudent approach is simply not to comment on any matters of litigation.

Okay. Well, thank you for all your questions. As always, it's great to hear from you in appreciation for what's on your mind, relative to what we've reported on for the quarter. As you know, this company is committed to confronting our health care system's challenges. We are focused on expanding access to high-quality affordable health care for all of our customers. And I also want to thank our associates for their continued commitment to serving our 40.6 million members every day. Thanks for your interest in Anthem, and we look forward to speaking with you soon at upcoming conferences. Again, thanks for dialing in and look forward to seeing you in the future. Thank you very much.

Operator

Ladies and gentlemen, this conference will be available for replay after 11 a.m. Eastern time today through May 10. You may access the AT&T teleconference replay system at any time by dialing 1 (800) 475-6701 and entering the access code 403153. International participants dial (320) 365-3844. That does conclude your conference for today. Thank you for your participation and for using AT&T Executive TeleConference. You may now disconnect.



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