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ANTM - Q2 2017 Anthem Inc Earnings Call

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OVERVIEW:

Co. reported 2Q17 operating revenues of $22.2b and GAAP EPS of $3.16. Expects 2017 operating revenues to be $88.5-89.5b and GAAP EPS to be greater than $10.35.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Anthem Second 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 Second Quarter 2017 Earnings Call. This is Doug Simpson, and 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 second 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.

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.

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

Thank you, Doug, and good morning. We're pleased to announce strong second quarter 2017 GAAP earnings per share of $3.16 and adjusted earnings per share of $3.37, with both membership and revenue tracking well.

Our second quarter financial results show that we are continuing to carry forward the strong momentum we built coming into the year and during the first quarter. Our membership growth, coupled with the strong quality of earnings so far in 2017, gives us confidence that the value proposition we bring to the marketplace is resonating well.

Within membership, both fully insured and self-funded enrollment continue to track well versus our expectation, as we ended the quarter with nearly 40.4 million members.

In the first 6 months of 2017, our membership has grown by 468,000 lives. We're particularly pleased with the membership trends in our commercial insured business, as both large and small group membership came in ahead of expectations again during the quarter.

Our membership results, on a consolidated basis, translated into second quarter operating revenues of $22.2 billion, an increase of $924 million or 4.3% versus the second quarter of 2016. During the quarter, our Individual enrollment declined by 107,000 lives, which was expected. Our total Individual enrollment of approximately 1.8 million members consists of 1.5 million ACA-compliant members and 300,000 non-ACA-compliant members.

Of the 1.5 million ACA-compliant members, approximately 1 million, or less than 2.5% of our total enrollment, were from the Individual exchanges. Self-funded enrollment in Local Group and National Accounts were in line with expectations.

Before I discuss the details of our business unit performance, I want to spend a few moments on the evolving policy landscape. As a company, we recognize that access to affordable and high-quality health care is immensely important and intensely personal for all Americans. Anthem has always been committed to our members and sought to provide value and limit disruption no matter their financial circumstances or health status.

Our commitment to all of our members, including the most vulnerable populations, has not changed and will not change in the face of what we believe will be an ongoing period of debate and policy and regulatory adjustments in health care.

State and federal regulatory and legislative changes will likely impact our Individual and Medicaid businesses, and we remain focused on informing government leaders as they develop policy to achieve the common goal of creating stable and affordable marketplaces.

For example: ensuring appropriate funding for all whom we serve; a balanced risk pool; effective rules and regulations that limit expensive abuses prevalent in today's marketplace; elimination of unnecessary taxes that add to the cost of insurance.

Altogether, Anthem will continue to contribute in an ongoing discussion in Washington and the states on behalf of our members and all Americans, as we work toward stability and sustainability by providing ideas built on experience, data and member feedback.

Turning back to our financial results, our strong second quarter financial performance reflected contributions from both the Commercial and Government segments.

In the Commercial business, we grew our Local Group insured enrollment by 22,000 lives, bringing our year-to-date enrollment growth to 69,000, despite a market that is shrinking overall.

Operating revenues were $10.3 billion in the second quarter of 2017, an increase of over $400 million or 4.1% versus the prior year quarter. The increase was primarily attributable to premium rate increases, reflecting overall cost trends in our Individual and Local Group businesses as well as enrollment grew, primarily in the Local Group business.

These increases were partially offset by the one-year waiver of the health insurance tax in 2017, which improved affordability for our members.

Our second quarter 2017 operating margin for Commercial of 9.4% declined by 150 basis points from 10.9% in the second quarter of 2016. The decline was largely due to the impact of less favorable adjustments to prior year risk-adjuster accruals, the one-year waiver of the health insurance tax in 2017 and higher performance-based incentive compensation accruals. The decline was partially offset by the impact of strong operating performance in our Local Group business and improved core medical cost experience in our Individual business.

In the Individual ACA-compliant business, our second quarter financial performance was in line with our most recent expectations. The overall morbidity levels of our enrollment, identified in the first quarter, has stayed consistent, giving us better line of sight into the expected claims experience.

Our updated 2017 guidance continues to assume that this business will operate at a slight loss for the year. We're focused on mitigating claims pressure through medical management capabilities.

At the end of June, we received the final 2016 risk-adjuster and reinsurance data from CMS and have updated our accruals. We're pleased that the reinsurance rate of 52.9% was slightly ahead of our expectations, and the significant risk adjustment receivable for the 2016 benefit year was in line with our expectations.

The work to determine our final 2018 market footprint in the Individual ACA-compliant business is not yet complete. We expect to provide additional clarity on our final 2018 market footprint during our third quarter call, not sooner. As a company, our strategy has been and will continue to be to only participate in rating regions where we have an appropriate level of confidence that these markets are on a path toward marketplace stability.

Thus far, we have notified state regulators of our decision to largely exit the Individual ACA-compliant marketplace in 3 of our states, which represents a little less than 10% of our total Individual ACA-compliant enrollment.

While we have filed initial rate requests in all of the other states, it is important to note that those filings do not necessarily indicate the final level of participation. There are still many areas of marketplace uncertainties, principally cost sharing reduction subsidy funding that make it challenging to be comfortable with the level of predictability of a sustainable marketplace.

If we aren't able to gain certainty on some of these items quickly, we do expect that we will need to revise our rate filings to further narrow our level of participation. That said, we are closely monitoring state and federal legislative and regulatory developments. And if the level of uncertainty in the marketplace is reduced, we would have increased confidence in our ability to predict the appropriate level of market participation.

Switching to the Government business. Membership was flat during the quarter, but we grew year-over-year operating revenues by 4.5% to $11.9 billion. Operating margin for the Government business was 2.5% during the second quarter of 2017, a decline of 150 basis points compared to the prior year. The decline was primarily due to higher performance-based incentive compensation accruals and the impact of the one-year waiver of the health insurance tax in 2017.

In our Medicaid business, our financial performance was largely in line with expectations outside of the Iowa contract. While our operating performance improved in Iowa versus the second quarter of 2016, it did underperform our expectations during the second quarter of 2017. We continue to believe the medical performance of the business supports higher rates than provided under the current contract. We remain highly engaged in working to secure actuarially sound rates that reflect the acuity of the populations we serve.

We continue to see a strong pipeline of RFP opportunities for future growth in the Medicaid business and expect 15 to 20 RFPs to be released over the next 1.5 years. The pipeline includes opportunities for new business in both new and existing states as well as reprocurements of existing contracts, which, in many cases, are for the potential for additional business beyond our current footprint.

Additionally, the pipeline is largely concentrated in new and specialized populations and services, such as long-term services and support and those with intellectual and developmental disabilities.

In these areas, Anthem has a proven track record of providing market-leading capabilities, which are necessary to effectively manage these vulnerable populations.

In the Medicare business, our core gross margin performance was in line with expectations. We continue to expect to organically grow our Medicare advantage enrollment by low to mid-double-digit percentages over the next few years, with a financial contribution that is within our long-term targeted operating margin range.

We also continue to target M&A opportunities to augment our growth profile. Turning to discuss our updated 2017 financial outlook, we now expect adjusted earnings per share of greater than $11.70 for the full year 2017, an increase of $0.10 from our previous outlook. Our updated outlook reflects the improved performance in our Commercial Local Group business and reflects the uncertain nature of the individual ACA-compliant marketplace.

Finally, as it relates to our PBM strategy, our pharmacy team is analyzing our options to create the best long-term pharmacy solution. While it would be premature to share specifics regarding the RFP process, we remain very confident in our ability to drive significant value for our clients, members and shareholders.

The RFP process has further validated our expectation to be able to lower our pharmacy costs by more than $3 billion annually once we transition to our future [state].

Should we decide to leave Express Scripts, we're very confident in our ability to thoughtfully plan for the transition of our customers to our new solution. A seamless transition for our members is a key component in our evaluation process, and we will be very focused on mitigating any potential abrasion for our customers throughout this process. We remain committed to informing the market of our long-term pharmacy strategy by the end of 2017.

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

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 second quarter.

On a GAAP basis, we reported earnings per share of $3.16. These results included net negative items of $0.21 per share. Excluding these items, our adjusted earnings per share was $3.37 for the quarter. These results reflect our strong underlying financial performance.

Operating revenues in the second quarter totaled $22.2 billion, an increase of $924 million or 4.3% versus the second quarter of 2016. The increase is primarily due to the premium rate increases across all lines of business to cover overall cost trends as well as higher enrollment in our Medicaid, Large Group and Medicare lines of businesses.

These increases were partially offset by the impact of the one-year waiver of the nontax deductible health insurance fee in 2017, which allowed us to reduce premiums in 2017 to help improve affordability.

Additionally, the increase was partially offset by less favorable adjustments to prior year risk-adjuster accruals compared to the second quarter of 2016.

The benefit expense ratio of 86.1% in the second quarter of 2017, an increase of 190 basis points from the prior year quarter. This expected increase was largely driven by the impact of the one-year waiver in health insurance tax, partially offset by improved medical cost performance in the Local Group and Individual businesses.

Our second quarter 2017 SG&A expense ratio of 13.8% came in higher than expected but still declined by 20 basis points from the 14% in the second quarter of 2016.

The decrease was primarily driven by the impact of the one-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 higher performance-based incentive compensation accruals and the 2015 cyber-attack litigation settlement that was recorded during the quarter.

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 half of 2017, we experienced favorable prior year reserve development of $951 million, which was moderately better than our expectations.

Our reserves continue to include a provision for adverse deviation in the mid- to high single-digit range, and we believe our reserve balances remain consistent and strong as of June 30, 2017.

Our Days in Claims Payable was 40.5 days as of June 30, largely unchanged from the 40.6 days we reported at the end of the first quarter. Our debt to cap ratio was 38.1% as of June 30, 2017, a decrease of 160 basis points from the 39.7% at the end of the first quarter, which reflects the impact of the repayment of a $529 million note that was due during the quarter and an increase in our shareholders' equity.

During the second quarter of 2017, we repurchased approximately 2.5 million shares of common stock for $458 million at a weighted average share price of $182.83, bringing our total year-to-date share repurchases to 2.8 million shares and a weighted average share price of $180.37.

As of June 30, 2017, the company had approximately $3.7 billion of board-approved share repurchase authorization remaining, which we intend to utilize over a multiyear period, subject to market conditions.

We ended the second quarter with approximately $2.8 billion of cash and investments at the parent company, and our investment portfolio was an unrealized gain position of approximately $846 million as of the end of the quarter.

For the 3Rs, we have adjusted our accruals to reflect the final 2016 benefit year data received by CMS at the end of June. As Joe mentioned, we were pleased that the reinsurance program came in slightly ahead of expectations and the risk-adjusted receivable we had accrued for 2016 was in line with our expectations.

For the 2017 benefit year, we continue to maintain a significant net receivable position for risk adjusters, and we have not changed our accounting policy for risk corridors. Our historical results have not benefited from the amounts due under the risk corridor program, and we continue recording a 100% valuation allowance for all unpaid receivables for the 2014, 2015 and 2016 benefit years.

Now moving to cash flow. For the second quarter 2017, we generated operating cash flow of $393 million or 0.5x net income. Cash flow in the second quarter included the impact of making 2 estimated federal tax payments, consistent with expectations.

On a year-to-date basis, operating cash flow was $3.1 billion or 1.7x net income. Our operating cash flow continues to reflect the impact of collecting an extra CMS Medicare payment in the first quarter, which is expected to reverse itself during the fourth quarter.

After adjusting for the Medicare prepayment, operating cash flow was still strong, reflecting the quality of our first half 2017 earnings. We used $172 million during the quarter for our cash dividend, and our Audit Committee approved the increase of our third quarter dividend by $0.05 to $0.70 per share. With this increase, we have increased our dividend every year since we began paying a dividend back in 2011.

Turning to our financial outlook. We increased our operating revenue guidance for 2017 by an additional $500 million to a range of $88.5 billion to $89.5 billion. This increase reflects higher-than-expected premium rates in the Federal Employee Program and Individual businesses.

We expect our fully insured membership to be in the range of 15.2 million to 15.3 million and our self-funded membership 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 higher-than-expected losses in BlueCard enrollment.

Taken together, we expect our total membership to be in the range of 40.2 million to 40.4 million members, nearly 300,000 to 500,000 lives higher than at the end of 2016.

Our 2017 medical loss ratio is projected to be 87%, plus or minus 30 basis points. We 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, the 2015 cyber-attack litigation settlement and Cigna-related transaction cost incurred in the first half of 2017. We expect our 2017 Local Group medical cost trends to be in the range of 6.5% to 7%, but they bias towards the lower end of the range.

We are encouraged by our first half 2017 operating cash flow, and we project operating cash flows to be greater than $3.5 billion, including potential cash payments related to a portion of the Treaty assessments and the 2015 cyber-attack litigation settlement.

Regarding capital deployment. Our 2017 outlook continues to include the benefit from $1.5 billion to $2 billion in share repurchases during the year.

To conclude, our 2017 earnings per share outlook is greater than $10.35 on a GAAP basis, and we have increased our adjusted earnings per share outlook by $0.10 per share to greater than $11.70.

Our updated outlook reflects the better-than-expected operating performance in our Local Group business and the uncertain nature of the Individual ACA-compliant marketplace.

It is important to note that our outlook does not include any additional transaction or legal costs associated with the terminated Cigna acquisition beyond those incurred in the first half 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, operator, please open up the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Ana Gupte from Leerink Partners.

Anagha A. Gupte - *Leerink Partners LLC, Research Division - MD, Healthcare Services and Senior Research Analyst*

On the guidance assumption of greater than $11.70, I was looking for more color on what's being baked in. On the exchange margins and the outlook that it will remain negative for the full year, is that conservative? Or is there something on the [2R] true-up that has driven continued conservatism? And then secondly on the 2016 Iowa true-up, is that already in guidance for the Medicaid? And as far as the first half of '17, have you included something where you haven't received the rate?

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

Ana, this is John. Thank you for the question. Let me see if I can answer both of those. So in terms of our raising guidance to greater than $11.70 per share, the exchange business, as you know, it's a -- there's a lot of moving parts associated with that. We had some true-ups here associated with the 2016 business, based on getting the final CMS information at the end of June. Fortunately, the true-ups were relatively small. The reinsurance paid out slightly higher than we expected. But on the risk adjusters, we were quite pleased with the analytics that we had done prior in the fact that what we ended up in terms of risk adjuster receivers and the magnitude of the receivables that we are entitled to, was virtually spot on what we had recorded, which really does show that we understand the -- that line of business and then really do have very great data analytics associated with that. So the true-up process itself really had minimal impact on our 2017 reported results.

And in terms of the outlook for the rest of the year, in the first quarter, there had been a bit of commentary associated with the morbidity. It was a bit higher than we had planned for, due to a shrinking risk pool and various other issues. So we've adjusted our thought process for our 2017 risk adjusters, and we believe that they're all relatively appropriately stated in terms of what's been recorded for the first 6 months and what's expected for the last 6 months. So I would not say that there's a significant amount of conservatism associated with the guidance related to exchanges as much as I would say that our track record is doing a pretty darn good job of predicting it. That's pretty much where we stand on that. Related to Iowa, we've not finalized a rate increase for July 1. We did experience higher-than-expected claims during the second quarter of '17. I'm not really going to go into much more detail than that. Yes, we did, at the beginning of 2017, receive a partial payment associated with a portion of the 2016 losses into the '17 period. And we continue to work with the state in Iowa in order to come up with actuarially justified rates for the future. So we really haven't taken that into consideration yet. We're hopeful there's some conservatism in those numbers. But until we finalize the work with the state and get actuarially justified rates, that's still a little bit of an open item.

Operator

Your next question comes from the line of A.J. Rice from UBS.

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

Just maybe I'll ask about the capital deployment. I know if I look at what you did in the current quarter, that's consistent with your $1.5 billion to $2.5 billion, you might even need to -- target for the year. You might even need to step up a little bit in the back half to get to where you're trying to be. But I also know that coming out of the Cigna transaction, I think Joe had mentioned in the spring at some events that there were some tuck-in MA type of deals that you were looking at. Something -- maybe things along the line of the Simply Healthcare deal you did a few years ago. Can you update us on your thinking about capital deployment there? And I know, Joe, you have a lot of interaction in Washington. Do you have -- have you gotten any sense of the administration and their views on industry consolidation relative to what you may have faced in previous administrations?

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

A.J., thanks for the question. Let me briefly address the capital, and then I'll turn it over to Joe to -- and he wants to talk about the rest of your question. So in terms of capital, you're exactly right that we'd begun our share buyback once the Cigna deal was terminated. And your thought process on we may need to do a little bit faster acceleration in the second half than we have so far. I would say on a weekly basis, we are exactly on track to delivering that $1.5 billion to $2 billion because we didn't start the share buyback until into the second quarter, because we didn't have the finalization of the Cigna thing until several weeks into the second quarter. So when you look at our path that we have in terms of share buyback on a weekly basis, we feel very good about our ability to deliver to -- back to the shareholders, the $1.5 billion to $2 billion. So anyway, Joe, I'll turn it over to you for the other part of A.J.'s question.

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

Good morning, A.J. Thanks for the question. Very quickly maybe chop your question up into a couple parts. First of all, regarding some prior comments regarding M&A around MA, we still are very focused on examining markets, market by market, looking at opportunities. Yes, we're still mindful of the opportunities for tuck-ins. We think that there certainly are opportunities that we should focus on very carefully, and so we're going to continue that pursuit. As you know, we've got an MA platform that is now restructured and completely ready for expansion both organically as well as by way of M&A. So we're going to keep our options open. We're going to continue to look at the right fit for us in the markets that we believe where we can perform at a very, very high level. And so we do have teams that are very actively engaged and focused on the best proposition possible. M&A, broadly speaking, is still a very significant long-term strategy for us, given that kind of an overarching theme is that it's still all about access, affordability and quality of services, both with respect to service as well as safety. We're very mindful of -- that the fact that scale does matter in this pursuit, and we will continue to very carefully examine the marketplace to assess our optionality, our targets and, hopefully, create fits that are really synergistic with respect to how we're going to best serve the marketplace. Great example of -- you may recall, a few years ago, the acquisition of Simply Healthcare probably stands out as the kind of transaction that I think will be incredibly beneficial to the company, not just serving the marketplace but also from a financial perspective, being a great fit with respect to the synergies that I mentioned a moment ago. Simply was an incredibly well-run company. And we, I think, were very pleased to be able to -- brought that into our portfolio, then being able to leverage off of that significant strength that it brought to us to continue to expand in the Florida marketplace. I think that, hopefully, that's responsive to the question about M&A and, more specifically, MA. Open for more questions there. With respect to the political landscape, I think we're all very observant of what's happening, I don't think it's an exaggeration, by the hour. Leading up to just maybe a week or so ago, we tried to stay very, very engaged in sharing our thoughts about what it would take to stabilize the marketplace. We do have ingredients that we have continually communicated as sort of the recipe or the ingredients to create stabilization in the marketplace, the ingredients that we believe will repair the Affordable Care Act issues that we've come upon repeatedly over the last few years. And we do believe we have been heard, A.J. With respect to how that all might play out in the end, with respect to policy decisions that will be made by way of a vote in Congress, I think is anybody's guess. But quite frankly, we do believe we have the ability to share our opinions. Our voice is heard, and we're hopeful that the kind of stabilization we believe is essential to best serve our marketplace is going to be embedded in whatever may come out of Congress. There are other points of view that maybe nothing will happen in the short run. I can't weigh in on that at all. I don't know. But again, we're very hopeful, and we do believe that stabilization is a distinct possibility. And obviously, as I said, we will continue to make the contributions necessary for our voice to be heard as well as the voice of the industry overall. So thanks for the question, and I look forward to maybe talking more about this as these policy decisions are created and put into force.

Operator

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

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

Just wanted to ask a couple of questions on the Individual business. First, in the 3 states where you're downsizing next year, do they contribute a disproportionate amount of the losses this year? I know it's a small percentage of membership, but would love to get a sense for how profitable those states are. And then, Joe, you commented that you might have to revisit your rates for 2018 if the level of uncertainty changes. Is that primarily CSRs? Or are other -- are there other reasons that you might have to come back and look at the rates?

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

Chris, thanks for the question, I'll address the first half, and that's about the 3 states. As you indicated, it is a very small component of our membership associated with individual exchanges. In terms of profitability, it really is not significant one way or another in terms of the overall profile for the individual book of business. So it, in and of itself, is not a significant driver in terms of 2017 expectations.

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

With respect to rates, you asked the question about what other characteristics of the market might influence our decisions around rate adjustment, clearly CSR is a standout. We've repeatedly said that, that aspect of pricing and the subsidies that support membership in our markets can translate to as much as a maybe 18% to 20% uptick in premium if subsidies aren't granted. It remains to be seen whether that will ultimately be allowed. But if not, then obviously, we're going to have to revisit our pricing market by market in order to judge whether or not pricing adjustment is necessary or even if reentry on any measure of scale is appropriate. As I said earlier, so much is dependent on the stability of each of those markets, which you may know. We have 139 rating regions. And so those rating regions are going to be carefully analyzed, sliced and diced and then determined if, quite frankly, a rating -- or excuse me, a premium increase is tolerable beyond a certain point. And if, in fact, we will be able to remain as an active participant in those rating regions. Right now, as you know, our extraction represents about 10% of membership. And our hope that

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between now and, let's say, through September, a lot of decisions will be made. But I can underscore that time is of the essence, and some of our critical decisions may have to occur in a relatively short period of time. So I would tell you that the decision making is going to be, as I say, fast and furious, and time is of the essence for us to make the right decisions for the benefit of the markets we serve, the membership we serve as well as for the company overall. John?

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

Thank you, Joe. And Chris, I was just going to maybe expand on your question about if CSR is the only issue. Maybe to sort of think through what that means when we talk about CSRs. If CSR -- without CSR funding, as Joe said, we're talking about incremental 20-plus percent rate increases. Well, we have 20-plus percent rate increases with [C&R], so those are additive to each other. And in order to come with a target margin with that level of rate increase is, really, a very difficult thing to do. And you look at, gee, if CSRs are not there, then what does that do to the number of people who are actually going to participate in the exchanges. And so then if that changes, how does that impact the risk profile or the risk pool associated with it. How will that then impact our ability to collect risk adjusters and to price for that and the various other aspects. So there really is -- this one item impacts multiple things downstream in terms of how we look and assess these things. So I just wanted to make sure it wasn't just the CSR, it was all the ramifications. And there are many associated with that.

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

Yes, and John's absolutely right. There's a cascading effect. One other key ingredient which is material is tax. And the tax, if they were to have the moratorium lifted, is probably something on order of 4% to 5% premium increase. So you can see the compounding effect of all of these issues that don't map to stabilization that then creates the cascading effect that John mentioned earlier. So again, that's all included in our analytics, specific to 139 rating regions that we are looking at very carefully to judge the in-and-out decisions that we have to make.

Operator

Your next question comes from the line of Christine Arnold from Cowen.

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

A couple of things. One, with respect to Iowa. What are your options? What if you don't get what you view as actuarially sound rates? Can you exit? I'm not sure what the contract gives you in terms of latitude. And then in D.C., I understand the whole issue with CSRs. How much can the administration do? Like if the Trump administration stops saying, "We're not going to fund this. We're going let it implode," is that enough? Or do you need legislation? And where do you think the administration can do something and is willing to versus where you need to see legislation?

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

Two parts, one Iowa, one CSR in terms of further exploring that issue. Regarding Iowa, we got a great state partner. And obviously, we've been engaged in dialogue with them for now quite a lengthy period of time. And we're very hopeful that, as John pointed out in his remarks, the actuarial soundness that we're pursuing, I think, will be made clear and the right decisions will be able to occur. And again, it's a work in process. And I think going beyond any kind of conversation at that level, I think, is not appropriate, given the intricacy of the dialogue that we're having with our state partners. And with respect to contract terms, obviously, probably -- in fact, cannot go into those terms at this time. But in the main, we do believe that, over time, we'll be able to have the right kind of facts laid out that demonstrates the degree of adjustments that are necessary to create the actuarial soundness that we need to continue to serve the membership in Iowa. So we're optimistic, but it is truly a work in process. With respect to CSR, there are a variety of paths, and obviously the first path focuses specifically on action taken by Congress and if CSRs will be embedded in a -- some type of legislative model. And that's going to have to kind of play out based on the votes that occur in Congress. Absent that, and again, I don't want to predict where all that might go with respect to yet again another path, but obviously, there may be other choices that may occur related to funding by other means, funding specific to an action taken by the administration. But I think put it all together, I believe that the leadership that we deal with in Washington are very mindful and fully aware of how CSR really maps to stabilization. And in particular, the effect on premium increases for the people that we serve across the country. So I think that, too, is a work in process, but it's -- yet remains to be seen exactly how that funding will flow to us to support our marketplace. We just don't know yet.

Operator

Your next question comes from the line of Matthew Borsch from BMO.

Matthew Borsch

Question, if you could just -- you had mentioned higher-than-expected enrollment losses -- or maybe it wasn't losses. Maybe it was slower growth in the BlueCard product. Can you just talk about that and talk about your outlook for your own large employer ASO National Account enrollment going into next year and how good a vehicle you think BlueCard is going to continue to be for you?

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

Sure. Thanks, Matt. So in terms of the BlueCard, as I, in the prepared comments, had talked about that, that was an offset to some of our other gains in terms of our overall membership outlook. And just to remind everyone, BlueCard is where it's [another] Blue Cross and Blue Shield carrier owns the account and has sold the account, and their member is a resident in our state is a typical methodology of how we obtain BlueCard membership. And that was a bit lower. However, as we look at the National Account selling season, we really are pleased with the expected growth in membership for '18. It's been a bit quiet for large jumbo National Accounts, but we're a very strong player in the market, and we expect to at least hold if not increase our market share in the National Account space. We've had some great success with 0 trend guarantees related to first-year customers. We have consistently delivered on that guarantee, providing value, saving customers medical cost. And we already have received a few RFPs for 2019. So we feel pretty good about our positioning. And quite honestly, we're not all that worried about the small drop in BlueCard membership year-over-year, because we think the National Accounts is -- that the sales cycle is going to work its way out and that we're going to do just fine.

Operator

Your next question comes from the line of Lance Wilkes from Bernstein.

Lance Arthur Wilkes - *Sanford C. Bernstein & Co., LLC., Research Division - Senior Analyst*

I wanted to ask a little bit about the PBM RFP process. And understand you can't go into the specifics on who's getting what right now. But if you could talk a little bit about what you've learned going through the process, in particular, your views on hybrid versus outsourcing, your views on which functions perhaps are best housed within your company? And also what segments on the insurance side do you think would benefit the most from a growth perspective from the improved pharmacy rates?

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

Great. Lance, thanks for the question regarding PBM. Questions really come at us repeatedly on this point, and obviously, it's evolutionary from the very beginning back in January of '16. And go back in time, we've always stated that we would make it very clear, quite frankly, make a clear statement of the choice we made in terms of contracting by the end of fourth quarter, and we still are committed to that. With respect to that, we've been engaged in a very analytical process. You all well know that RFPs went to the market, and we now have received those RFPs and are in an analytical mode that's very thoughtful, very thorough. And as we've repeatedly said, we think our pursuit has always been about optionality. And constructing a hybrid model has been one of those options that we've carefully evaluated, meaning that we have probably multiple paths that can best serve our customers, our members, whether it's a mail order proposition that is sent out to someone to administer by way of maybe private labeling it, the fact that we will always retain control of our formulary. And then other characteristics of a hybrid model, which represent various constructs within a model that equates to great value for our membership. Of course, the other extreme would be to send it all out to another vendor. And so we've always been mindful of the many choices we have, which I think speaks to the power, the significance of optionality being very much in our favor. We've stood by, as you well know, our expectation in terms of $3 billion per year in terms of savings, go forward, at 1/1/20 and beyond. And nothing that has occurred thus far has moved us off of that expectation. And so again we're working very carefully with respect to the analytics around an RFP. I do want to underscore that it's not just about the money. It has a lot to do with customer service, our commitment to a transition that is virtually seamless, given the complexities. We well recognize that. And so whichever direction we go in, we will be very careful on our choices regarding best serving our customers with a seamless transition. So it's, obviously, a complicated formula for success, but it's literally -- it's all hands on deck to get us from today to 1/1/20. And I feel really good about the path we're on. And I don't think there are any complexities that we aren't aware of and working on. And I think we, again, feel very, very good about the process and what potential will come our way in terms of very positive characteristics beginning 1/1/20. John?

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

Thank you, Joe. And Lance, in terms of the second part of your question of growth areas, I'm not understating this when I say that it will impact and help every line of business we have. And in terms of existing business, it will be very significant. For new business and maybe specifically, the question you're looking for is that we believe it will make our Medicare business that much more competitive, our Medicare Part D that much more competitive. We are growing that because of all the other benefits and things that we offer to the marketplace. We think it will really help accelerate the growth in that area. And then in the large group ASO, it's not uncommon to have a PBM carveout as part of the National Accounts or the large group ASO. And we believe that we can minimize the PBM carveouts on that in the future, as just 2 examples. But when I say it will help every line of business, we believe it will help every line of business.

Operator

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

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

Just got a quick question on Individual and then a follow-up on Medicaid. So Joe, on the Individual ACA-compliant business, you've previously indicated a focus on getting to profitability here in 2018 or exiting where you needed to. Understanding that there's still unknowns, should that still be our expectation next year in terms of how you're making decisions in this business?

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

Justin, thanks for the question specific to this continued formation of the ACA marketplace. We've always said that our target is 3% to 5% margin. We certainly haven't backed off of that. As you can imagine, with the day-to-day grind of best managing that portfolio is governed in large measure by rules of engagement and the stabilization necessities that I talked about earlier coming to reality, our sense is that stabilization is a distinct possibility. We are still committed to the 3% to 5% margin performance. And we're also committed, as I've said repeatedly over nearly a year now going back to last summer, kind of worked off the characterization of surgical extraction. We still are very focused on that as well. And I think, Justin, that we will make the right decisions with respect to engagement of market, detachment from a market. Our hope is that we will be able to continue to perform in a very robust and meaningful manner in all 139 rating regions. But so much depends on how the legislative process plays out and what stabilization rules are put into place. But again, I'll reiterate, we're still hopeful that a 3% to 5% margin is achievable. And so John, I don't know if you want to add to kind of the outlook and how engaged we are in making that a reality.

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

Yes, so no, Justin, as Joe said, we're committed to that. I just maybe wanted to reframe the 2018 commentary you said. Back in 2014, we did extremely well in exchanges. And then 2015, we ended up being closer to breakeven, and that's when we really saw how the co-ops were pricing on an irrational basis. Some of the other issues were going on in terms of the stability of the marketplace. And we looked at it and thought it would take a few years for all that to work its way through, again, for some of the co-ops to continue to exit. And we predicted that it wouldn't be until 2018 until the marketplace obtained stability. So we still, as Joe said, believe that that's possible with the appropriate regulatory and legislative changes. But as you phrased your question, I would say the short answer is yes. We want to ensure that there is a path to target margins in a sustainable marketplace. Did you have a follow-up on Medicaid?

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

Just to repeat. Medicaid rates for '18, anything you could tell us there? And specifically, the Governor's budget indicated in California that 2018 Medicaid expansion rates might be cut high single digits. Just want to hear what you guys saw there in California Medicaid expansion particularly.

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

Thanks, Justin. So in terms of 2018 in Medicaid, it's a little premature to talk about the specificity, and we really would prefer not to talk any one state. We're in -- closing in on being in 50% of the states of America in terms of providing Medicaid services. And as you can imagine, within all those states, some do a little bit better, and some don't do as well as we would have liked, and it's really a portfolio type approach. And it's really, I think, premature to discuss any one particular state, especially for 2018, other than to say that we are extremely high on the pipeline associated with future Medicaid opportunities and continue to capitalize on that. And we do see it as a growth area for the company, even without Medicaid expansion in the future with all the other various long-term support services, aged, blind, disabled and various other things that are all part of the future pipeline. So Medicaid clearly is continuing to be a growth area for us in the future.

Operator

Your next question comes from the line of Sarah James from Piper Jaffray.

Sarah Elizabeth James - *Piper Jaffray Companies, Research Division - Senior Research Analyst*

We're seeing an investment cycle pickup at your peers in adding to IT and analytic assets, especially in the artificial intelligence area, which feeds into strategy decisions around benefit design and underwriting. So can you speak to where Anthem is in the investment cycle on IT and what Anthem is doing specifically on the AI front?

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

Sarah, that's kind of the question that is very powerful perspective on the future of our industry. I've been a great believer that the so-called secret sauce for our performance in the marketplace moving in the future is all about translating dated information; meaningful information that supports our provider community especially in terms of better choices that they can make in and around evidence-based practice; information that supports the needs of our consumers, given the significant risk position that they're now being subjected to in terms of higher deductibles, et cetera. They need to make very well-informed decisions in terms of accessing health care and remaining healthy. Therefore, we're very committed to the well-being of all of our members. In that regard, to your point about artificial intelligence and the foundational aspect of how you support the development of useful information, we're investing quite heavily with respect to data infrastructure, foundational build-out with respect to our IT systems. We are definitely using artificial intelligence today in optimizing our ACA benefits across 139 rating regencies -- excuse me, regions. And actually, this has been a 3-year journey for us in the AI space specific to that process. Again, I do want to underscore, we well recognize that this is the future of a very successful health benefit manager. And in that regard, the appropriate amount of funding is being distributed, allocated to our technologies that will advance artificial intelligence that can best support the needs of all the interests that we engage with, whether it's a provider or consumer, government, what have you. We are intimately involved in building out that kind of capability today. Hopefully, in the near future, we'll be able to talk more about that. So thanks for the question. It was very appropriate and very significant.

Operator

I'd now like to turn the conference back to the company's management with the closing comments.

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

Great. Thank you, operator. And thank you all for your questions. They were great questions today. I just want to underscore that as a company, we remain committed to confronting some really tough questions and challenges in and around the health care delivery system, as we are focused on expanding access to high-quality, affordable health care for our customers. And I think that it's really critical for me to underscore the key contributors to that success being our associates, who've given continued support to the company and to our customers, which total 40.4 million members. And our associates do that every day with incredible commitment. Thank you, all, for your interest in Anthem, and we look forward to speaking with you soon at upcoming conferences. Thank you very much for the time.

Operator

Ladies and gentlemen, this conference will be available for replay after 11 a.m. Eastern Time today through August 19. You may access the AT&T Teleconference Replay System at any time by dialing 1 (800) 475-6701 and entering the access code 403156. 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.