Aetna Inc at Credit Suisse Healthcare Conference - Final

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Presentation

UNIDENTIFIED PARTICIPANT CREDIT SUISSE, ANALYST: Very pleased to have Aetna here to present next. Here from the Company to present we have Shawn Guertin. Shawn is Executive Vice President and Chief Financial Officer. So with that, I'll pass it over to Shawn.

SHAWN GUERTIN, EVP, CFO, AETNA, INC.: Great. Thank you, Scott, and good afternoon, everyone. Our presentation today you can find on the Investors Relations section of aetna.com. It includes -- direct your attention to the cautionary statement that's included there and also all of our SEC filings for a complete description of the risk factors impacting our business.

I want to start out today talking a little bit about things we tend sometimes to talk about at the end, which is multi-year performance. On our earnings call we updated our guidance for the year -- $7.45 to $7.55. That's about a 12% year-over-year increase and that caps off a five-year period where we've grown earnings in excess of 14% over this period.

The reason I put this up is not because we pick these dates arbitrarily or that they were the dates that made the numbers work. It was really -- goes back to in early 2011, at the investor event that happened early that year, we laid out the core elements of our strategy and we also laid out our goal to grow EPS low double digit on average over time.

And as you can see here, we have done that and actually probably hit the -- done better than that over the last five years. And I think that speaks very well to the momentum that we have going into the next five years as we think about Humana, and we talk about that later.

Commensurate with that kind of return, our shareholder returns have also been outstanding during this period, whether you want to measure that against our peer group, whether you want to measure that against the S&P 500. It's been a very, very good run for the stock through this period.

And I'd like to think that a lot of this has to do with the consistency of our strategy -- we've really been singing from the same hymnal throughout this period. And our focus on executing against that strategy, whether that's growing the government business, whether that is deploying capital smartly to drive growth, whether that's improving quality from a consumer perspective, which you see in our Medicare Star ratings. We've really been consistently marching to the beat of the same drummer throughout this period, and I think that's a lot of what's behind this.

But the focus is on continuing to deliver results, and 2015 has been a very good year in that regard. You can see we have exceeded consensus and raised four times this year, so it's been a very strong year performance-wise.

Looking behind this, our group commercial business has performed very well this year and over all, our commercial business has been stable and steady as a block, and I'll dive into this a little bit more.

What's really driven the outperformance this year has been the government business. The government business, both Medicare and Medicaid, has had an extraordinary year and actually a couple of good years in a row now. If you look at the top line of these businesses, on Medicare Advantage we've grown individual Medicare Advantage membership low double digits this year; that's been an outstanding story.

Medicaid revenue is up almost 10% year over year, and that's despite the fact that we exited an $800-million contract in Delaware at the end of last year for profitability reasons. So I think that revenue growth not only speaks to the strength we have in our Medicaid operations and how quickly that's growing, which I think sometimes is overlooked in our story because we talk about Medicare a lot, but it also speaks to our commitment that when we don't see a pathway to profitability, we're not going to get obsessed with just having the revenue -- we are going to exit that contract, and that's indeed what we did in Delaware.

From a margin profile, the Medicaid business performed well last year, has continued to perform very well this year.

Medicare Advantage, we are in a little bit of a different place as a Company in that we were trying to actually improve that margin and get into the mid-single-digit target margin range. And that's gone very well. In fact, we probably have achieved -- we have achieved that goal this year and that's probably about one year earlier than we thought we might have at the beginning of the year. So that has gone very well, and with that has come the growth, as I mentioned. With that has come industry-leading Star ratings as well.

Thinking about these businesses going forward, we've talked a lot about Kentucky Medicaid -- that's our biggest contract. We did get our rates reset in July of this year; it's still a very good contract for us. But that will probably push margin next year, where I think the Medicare Advantage business, we will look to continue that business in the mid-single-digit margin range next year.

As I mentioned, commercial, over all, has been stable. And this is important because this isn't accidental. We've been very deliberate in trying to keep this loss ratio for commercial, which is still the biggest source of earnings we have, stable and consistent and predictable, and we've been willing to exchange a little bit of growth for that. 2013, this was 80.1%; 2014, it was 80.2%. The current consensus average is around 80.4%, 80.5%, and that's pretty consistent with our internal projections. So it's been in a nice tight [shot] group, and that's exactly what we've been trying to achieve here.

What's happened -- there's been a few things going on here. As I mentioned, the large group business has done exceptionally well. And our non-ACA business has done exceptionally well; most blocks are running at or better than expected. The ACA business, which is both individual and small group, that business has been pressured. And I will talk more about that in a few slides in terms of how that business is performing and the opportunity we have to improve that going into 2016.

So as you shift to 2016, I want to go back a little bit through what we went through on the earnings call, and it starts with trying to reestablish a baseline of performance that we're carrying. Most of you know that as a matter of course, we do not include, or try to project, prior-year development in our initial guidance. So the biggest adjustment here is the removal of that from this year's earnings, and there's a few other things that we've adjusted for -- the $0.10 is the net [bad guy] we've taken this year in terms of the 3Rs.

As I mentioned, we don't try to predict the prior-year development, and I caution people who do so. But I do know that some of you, and certainly some analysts, do try to make a call on this. And so I wanted to just offer some commentary on this, at least as it pertains to the last couple of years and how that might change your thinking going forward.

First of all, the $0.60 -- probably the biggest number we've ever had. And so to just sort of as a default assume that recurs is a leap of faith that I think you've got to think through just on basic principles; like I said, it's the best number we've had.

But when you really look at this in comparison to the last couple of years, the commercial number is good but it's not particularly extraordinary in terms of the last couple of years. The reason this is so much higher is really due to the government business -- the Medicaid and the Medicare.

What you had here was in Medicaid a lot of this is Kentucky, and we've talked about that. These were businesses that had challenges that were managing, that were getting better and they were on a certain trajectory. And that trajectory has stabilized a lot during 2015.

And so when I think about this, the conditions that gave rise to these levels of prior-year development, it seems less likely to me that I would expect to see this. It's always possible that you could get this number or more, but when you think about how these businesses were performing, they're in a much better place today, they're in a much more stable place today, and so to expect this kind of favorable development to come out, again, just as a default assumption, I think that's less likely to happen than it was a year ago.

So thinking about the challenges and opportunities, we think over all that we can take that baseline and grow that by at least 10%; that's our goal. We're not done with our planning process but we're certainly shooting for that goal.

And what we see as the big pluses and minuses are laid out on this slide. The first two have to do with some large group activity. We're losing some large accounts, we're keeping some of the accounts but losing some membership as they introduce other payers -- that's one of the things that's dragging us. We've talked about the Kentucky Medicare rate reset and we've said that's worth around $0.15.

As a result of the pending Humana deal, we've suspended share repurchase, and that is something typically that was part of our go-forward EPS formula. That's probably in the range of $0.25 or $0.30 when you want to think about it compared to maybe what we would have thought without that constraint.

Turning to the opportunity side, we do expect we'll continue to see growth, good top-line growth, in Medicare and Medicaid. But the bottom two are really the two that have the biggest impact year over year. The fixed cost leverage -- obviously as we grow revenue, to the extent that we can get productivity gains and drive our SG&A ratio down, this is a high fixed-expense business and that's always a big opportunity on our revenue base. That's not easy, but it is more in our control than other things. But that's a big component as we think about this going forward.

The middle one, though, is also a very large component, and it goes back to what I talked to, what's been straining performance in 2015 becomes an opportunity in 2016, and that is improving the margin on our ACA-compliant business. And so let me talk a little bit more about that.

The first thing that I need to do here is just be clear that when we talk about our ACA-compliant business, that is not our individual business only. As you can see here, we have a $7 billion block of small group. About half of that is in ACA plans and subject to ACA rating and reform. So that's about $3.5 billion.

That business is not at target margin right now, and that's dragging down the overall performance of small group. So hold that thought, that we have the $3.5 billion of ACA small group that's below target margin.

You can see the bottom two pieces are in essence our ACA individual business -- $3.5 billion. The off-exchange business is actually doing much better this year, but it's still around break-even. The on-exchange business is unprofitable. And over all, as a block, that business is unprofitable for us this year, probably to the tune in our forecast of sort of a mid-single-digit negative margin.

So on both of these, as we think forward, we're not forecasting or assuming that I can take these things all the way from where they are all the way to like a bust-out target margin. But I do think we can make improvements in this business. I do think we can move this individual business mix from a mid-single-digit negative margin up a lot closer to break-even. And we can probably get 300, 400 basis points on the ACA small group.

And so, why do I think that? If these were such difficult performers this year, why do I have the confidence in that? Well, there's a few things. One is I think it's instructive to go back to how we got where we are in 2015, and that goes back to when did we price this business in 2014? We priced this business in early to mid-2014. We didn't have a shred of data on the ACA membership in individual and small group. We had never seen anything on risk adjustment. And so many years, the 2015 pricing was just an extension of some of the assumptions you had to make in the 2014 pricing.

We know a lot more today about this business. We have a year of experience. We've seen risk adjustment. We know a lot more about the performance of the different plans, and so while our information is still far from perfect, the knowledge and the thought process that went into our forward pricing on this business, I think, was far better this year than it was last year. And so we've pushed rate increases probably in the low teens on this business going forward.

The second is, we're doing a lot more. This is a maturing process. We're doing a lot more as it pertains to medical management, we're doing a lot more as it pertains to risk adjustment. And I think that has to have a positive effect as well.

And thirdly, we've made some decisions around market participation -- or, to be more specific, not participating in certain markets -- with an eye towards getting the margin improvement here. That's also what we've done for 20--
So while again, I'm not going to be so sanguine that we can take this from a negative mid-single-digit margin and throw it all the way over to a positive mid-single-digit margin, but I do think we can make inroads into this

business in 2016. And again, that will be a significant component of how we think about year-over-year earnings growth for next year.

So our growth strategy going forward -- this is a depiction, sort of a simplified depiction, of a process we went through earlier this year and we've gone through in our strategy process, to say, where are the growth opportunities and how do they line up with the margin profile of the various businesses?

And no surprise, given what we ended up doing, that we thought Medicare Advantage was the place that had the most demonstrable growth top-line characteristics but also an ability to sustain mid-single-digit margins. You could argue that Medicaid might be growing faster, but the margin profile there, obviously, has been a little bit more challenged. So we think that Medicare Advantage is the best mid-term opportunity that balances top-line growth and margin characteristics.

And so, no surprise, we ended up obviously really being excited about and wanting to do the Humana acquisition. Coming into this year on a standalone basis, 60% or so of our revenue, and certainly the majority of our earnings, were still driven by commercial business despite all the growth we have had in government programs.

You can see in the post -- on the combined company basis, we have a lot more revenue exposure to government programs, and in many ways a much more balanced earnings profile as a company than we started the year with. And I think this fundamentally improves the positioning of the Company from a growth standpoint going forward given our increased exposure to the government program's revenue base.

I said -- right after the deal, I talked to a lot of people. And I think it's worthwhile going back through. There were three things that I really liked about the deal and were reasons to get excited about it. One, going back to the prior slide, was, we had the opportunity to acquire the preeminent franchise in what we thought was the best growth opportunity. That just doesn't come along every day. And so the Medicare Advantage franchise here and the Medicare Advantage business is really, at its heart, obviously why you would do this. It's 70% of Humana as a company; they've been industry leaders in this for a long time. On a combined basis, we're No. 1.

And maybe more important than just how big you are is your breadth. And before Humana, our footprint as Aetna covered about 45% of the Medicare eligibles in the country. So when you think about something that has these inexorable growth dynamics from the baby boomers coming in, and it's almost like a tide that can't be stopped from a growth standpoint, you want to be in as many places as you can as quickly as you can to capture that growth.

Post Humana, we have the widest footprint in the industry and we cover 90% of the Medicare eligibles in the country. So that is strategically a huge step forward for us, and something that I think positions us really well. So Medicare was No. 1.

No. 2, as I mentioned, they have a group commercial business that isn't in the mainstream of what they do; Medicare is. And we know how to fix that and we can make that business better; that's been the core business at Aetna for a long time and we can make that better, and I always like to find things that we know how to make better pretty quickly.

And then, the third was the healthcare services assets. Some of these assets are clinical-based. You know about the PVM. Our ability to focus some of these assets on the Aetna business could unlock a lot of value and this gives us a lot of optionality down the road.

It's important to keep in mind, obviously, these three things because it was at the heart of why we did this. When I look back -- certainly you saw last week Humana announced their third quarter earnings. And what I certainly see that I like about that picture is that the things that really drive long-term value here -- Medicare Advantage, healthcare services -- it's only a quarter since we did the deal, but those businesses, they're performing well. They were stable in the quarter and that's really why we did the deal; that's the business that's going to drive long-term value and they had good quarters and stable quarters on both fronts. And that certainly makes me feel good about the deal and our model that we have up there for the deal.

So when I think about the strength of our underlying performance on a standalone basis at Aetna, we have a very achievable, I think, deal case. We do not have, I think, overly ambitious membership growth for Medicare Advantage; we've talked about that being in the mid single digits, sort of industry-type growth.

I think we have a very achieveable synergy number built in there as well. We remain committed to our goal to achieve at least $11 in operating EPS in 2018 as a combined company.

So I will stop there, Scott, and Q&A?

Questions and Answers

UNIDENTIFIED PARTICIPANT CREDIT SUISSE: Yes, I think we have time for one. So Shawn, why don't I kick one off? First of all, thanks for the new disclosures around some of the plans to improve the individual and small-group business. And I think that gives us some new data, new concepts, to chew over. So I'll dig right into that.

Maybe first, just on the target to grow the on-exchange individual margin, improve that from negative mid single digits back to break-even. How sensitive is that forecast to the level of market growth in the exchanges? Because clearly we have a very wide range of government forecasts at this point -- CBO and [ETHERS] at over $20 million and HHS well below that at around $10 million.

So is this something that, just through your own pricing and just your own internal execution, you feel you can get there, or are you assuming a certain level of sort of churn and growth in the market as well?

SHAWN GUERTIN: We're assuming a level of growth in the market. The one thing we've been able to do because all of the pricing is public -- so we've been able to get a better look at our positioning in the markets. And so I do believe that we will be able to grow our membership next year and grow revenue.

And so it's an element of the forward story, but frankly, the issue that I think about more is really the margin improvement more than the volume. The volume could certainly vary from that, but the real leverage is going to be in what degree of margin improvement that we can realize.

UNIDENTIFIED PARTICIPANT CREDIT SUISSE: And just a sort of related question to that. So in the third quarter, clearly there was a pronounced impact on the exchange market over all for the industry. And we saw a cretin membership peel off a little bit faster than we would typically think about happening in terms of normal attrition in the third quarter pretty much across for every company there.

I know it's still early since then, but have you been able to drill in at all in terms of the membership that did come off and attrited during the third quarter? What type of profile do those members have? Did it look like it was some of the younger, healthier people who may not be paying premiums or did it seem like it was more of a balanced profile in terms of who's dropping coverage in the third quarter?

SHAWN GUERTIN: The phenomena that we're really seeing this year that didn't exist to the same degree -- it existed, but there's far more of it this year -- is there's a lot more people coming in and out of the system. And in particular, the people coming in in the special enrollment period -- i.e., outside of open enrollment -- and then staying for only a few months and then dropping again, and obviously getting service along the way, is really part of what's straining this picture. It's certainly not the total story, but the degree to which we're seeing that is far more elevated this year than it certainly was in the first year of the program.

That's been certainly one of the things that we've spent a lot of time looking at and needs to be thought through about this program going forward. All that in and out obviously is not real conducive to having a good balanced risk pool for the long term.

UNIDENTIFIED PARTICIPANT CREDIT SUISSE: Okay, great. Well, we're out of time. (Conference instructions)

SHAWN GUERTIN: Great, thank you.

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