31-Jan-2017

Aetna, Inc. (AET)

Q4 2016 Earnings Call

CORPORATE PARTICIPANTS

Joseph Krocheski
Vice President-Investor Relations, Aetna, Inc.

Mark T. Bertolini
Chairman & Chief Executive Officer, Aetna, Inc.

Shawn M. Guertin
Chief Financial Officer, Executive Vice President & Chief Enterprise Risk Officer, Aetna, Inc.

Karen S. Lynch
President, Aetna, Inc.

OTHER PARTICIPANTS

Joshua Raskin
Analyst, Barclays Capital, Inc.

Justin Lake
Analyst, Wolfe Research LLC

A.J. Rice
Analyst, UBS Securities LLC

Matthew Borsch
Analyst, Goldman Sachs & Co.

Kevin Mark Fischbeck
Analyst, Bank of America Merrill Lynch

David Howard Windley
Analyst, Jefferies LLC

Christine Arnold
Analyst, Cowen and Company LLC

Gary P. Taylor
Analyst, JPMorgan Securities LLC

Scott Fidel
Analyst, Credit Suisse Securities (USA) LLC (Broker)

Sarah E. James
Analyst, Piper Jaffray & Co. (Broker)

Peter Heinz Costa
Analyst, Wells Fargo Securities LLC

Lance Arthur Wilkes
Analyst, Sanford C. Bernstein & Co. LLC

Michael Newshel
Analyst, Evercore Group LLC

Michael J. Baker
Analyst, Raymond James & Associates, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning. My name is Rob, and I'll be your conference facilitator today. At this time I will like to welcome everyone to the Aetna Fourth Quarter and Full Year 2016 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer period. As a reminder, this conference is being recorded. I would now like to turn the conference over to Joe Krocheski, Vice-President of Investor Relations. Mr. Krocheski, you may begin.

Joseph Krocheski

Vice President-Investor Relations, Aetna, Inc.

Good morning. And thank you for joining Aetna's Fourth Quarter 2016 earnings call and webcast. This is Joe Krocheski, Vice-President of Investor Relations for Aetna, and with me this morning are Aetna's Chairman and Chief Executive Officer, Mark Bertolini, and Chief Financial Officer, Shawn Guertin. Following the prepared portion of the remarks we will answer your questions. Karen Lynch, Aetna's President, will also join us for the Q&A session. As a reminder, during this call we will make forward-looking statements. Risk factors that may impact those statements and could cause actual future results to differ materially from current projected results are described in this morning's press release and the reports that we file with the SEC. We have also provided reconciliations of certain non-GAAP measures in our press release and guidance summary.

Further, to assist investors in understanding our initial 2017 guidance, we have prepared a short presentation with additional details on our outlook and related reconciliations. The reconciliations and presentation are available on the Investor Information section of Aetna.com. Finally, as you know our ability to respond to certain inquiries from investors and analysts in nonpublic forums is limited so we invite you to ask all questions of a material nature on this call. With that, I will turn the call over to Mark Bertolini. Mark?

Mark T. Bertolini

Chairman & Chief Executive Officer, Aetna, Inc.

Good morning. Thank you, Joe, and thank you all for joining us today. This morning Aetna reported fourth quarter operating EPS of $1.63, a 19% increase over fourth quarter of 2015. Out-performance in all of our major products more than offset ongoing losses in our Individual Commercial ACA-compliant products, which were $100 million worse than we had previously projected. Our strong fourth quarter result brings full-year 2016 operating EPS to $8.23, exceeding the top end of our guidance range. Underlying these full-year results, we ended the year with 23.1 million medical members, consistent with year-end membership projections. We grew operating revenue by nearly 5% to $63 billion, we delivered strong operating results from our Government business, we drove continued operating efficiencies as evidenced by our 18.1% adjusted operating expense ratio, we achieved a high single-digit pre-tax operating margin consistent with our long-term target, and we generated strong cash flow in 2016, putting us in a strong capital position as we enter 2017. Based on the strong finish to 2016, this morning we provided an initial 2017 operating EPS projection of at least $8.55 per share. Consistent with past practice, this projection excludes the impact to prior year's reserve development.

In a few moments, Shawn will discuss 2016 results and 2017 guidance in greater detail. But first I would like to provide some brief comments on last week's U.S. District Court ruling enjoining our pending acquisition of Humana and then discuss some of the operational highlights for the year.

Beginning with the Court ruling, we are disappointed in the Court's decision as we believe we put forward a compelling case that addressed each of the Department of Justice's concerns. We continue to believe this transformative combination will result in a broader choice of products, access to higher quality and more affordable care, and a better overall experience for consumers. Given the clear benefits of combining these two great companies, we are conducting a thorough review of the Court's opinion and considering our options for responding to this ruling, including an appeal. We expect to complete our review prior to the end date of our merger agreement, and we'll communicate our decision at the appropriate time. Let me be clear: Our commitment to our strategy has never been stronger. Humana offers one way to accelerate that strategy.

We are continuing to make investments in digital tools and differentiated care models to provide our members with access to simple, high-quality affordable products that help them achieve their best health. These investments position Aetna to continue to be part of the solution in an evolving healthcare landscape. Regardless of the Court's decision, we intend to maintain focus on delivering strong operating results and providing the same high-quality products and services that our members have come to expect from Aetna. We remain convinced of the strength of Aetna's positioning and growth trajectory as a standalone company.

Moving on to 2016 operational highlights, our Medicare business continues to be a meaningful source of growth for Aetna and performed very well in 2016. During the year, we grew medical membership by nearly 13% including nearly 9% in Medicare Advantage and 21% in Medicare Supplement, drove year-over-year premium growth of 15%, produced solid operating margins consistent with our targeted range, and increased the percent of members in 4-star or better plans to an industry-leading 93% based on first quarter 2017 membership projections. Additionally, we had another strong Medicare Advantage annual election period and project that we will grow our total Medicare medical membership by 120,000 in the first quarter of 2017, including 12% growth in our individual Medicare Advantage membership.

Further, we are encouraged by a strong Group Medicare Advantage pipeline and the prospect for solid growth in 2018.

Our continued above-average growth directly speaks to the importance of our top-tier star ratings and our focus on creating more healthy days for our members. One way we measure our success is by how well we are able to keep our members out of the hospital and in their homes and communities. For example, in 2016, we reduced total acute admissions by approximately 4%, and we deployed predictive modeling to target members at the greatest risk of readmission. With the use of multidisciplinary care teams to engage facilities to develop appropriate and effective discharge plans, we achieved a 27% reduction in readmission rates. Collectively, these clinical programs have driven a best-in-class Stars readmission rate among national competitors.

Continuing with our Government business, from a financial performance perspective, our Medicaid business performed well in 2016. For the full year, we served 174,000 new members. We grew our full-year revenue by 13% compared to 2015, and we achieved strong pre-tax operating margins for the year despite the headwind from the rate reset in Kentucky. While pleased with our Medicaid financial performance in 2016, we are disappointed by our 2016 Medicaid procurement efforts. Despite the headwind this presents for 2017, we are encouraged by our successes in Nevada and Virginia and view our number one and number two rankings respectively in those procurement efforts as validation of our capabilities and revamped RFP process. Our strong showing in those states gives us confidence that Aetna could continue to grow in Medicaid beyond 2017 with our proven track record of successfully managing Medicaid populations for our state partners and a solid pipeline of opportunities across existing and de novo states.

Shifting to our Commercial business, our Large Group Commercial products performed well in 2016 achieving bottom line results that exceeded our initial expectations. We grew membership modestly in our Large Group Commercial Insured products, and medical cost trends for these products remain moderate and largely consistent with expectations. Our Commercial ASC and fee based businesses also performed well as positive fee yields and a focus on cost control produced another year of solid results. Moving beyond the financial accomplishments of 2016, we successfully advanced our strategy to help transform the healthcare system from volume-based payment models to ones that reward the quality and value provided.

We formed multiple collaborations with healthcare providers that span a wide spectrum of value-based care models including two new joint venture relationships. We carried that momentum into 2017 with the announced signing of a new joint venture with Allina Health in Minneapolis. All-in, we made solid progress in 2016 with over 45% of Aetna's medical spend currently running through some form of value-based care model, positioning us to achieve our 2020 goal of 75%.

Finally, before I turn the call over to Shawn, I would like to provide some thoughts on the evolving policy landscape. In spite of the best intentions of Washington and industry, the intended goals of the ACA have not been achieved. Millions of Americans remain uninsured and still lack access to affordable healthcare. Companies that have offered public exchange products, including Aetna and other for-profit and nonprofit companies, have collectively lost billions of dollars. These losses have forced most insurers to either scale back their participation or exit completely and in some cases even shut down, as is the case with the vast majority of the Co-Ops. The result is higher costs and more limited access for consumers.

As the public exchanges enter their fourth year, it is clear that in the absence of a significant shift in regulatory policy, the risk pools for the ACA-compliant Individual Commercial products will continue to deteriorate. However, we remain optimistic that the next wave of healthcare reform will focus on affordability, quality, and addressing the needs of the millions of Americans who remain uninsured or lack access to affordable healthcare. To that end, we continue to actively engage in constructive dialogue with lawmakers and regulators and are committed to working towards preserving the positive aspects of the ACA and developing consumer-based approaches that deliver access to affordable quality healthcare to all Americans.

In summary, I am pleased with our 2016 results, which exceeded our previous projections. I have a great deal of confidence in Aetna's future, including our long-term prospects for growth. Specifically, I am confident we have the right strategy to deliver long-term value to the people we serve and our shareholders, the right leadership to execute on our strategy, and the financial strength to deliver long-term growth. I want to thank all of our employees for their dedication to meeting the needs of the people we serve and delivering another strong quarter and year for Aetna and our shareholders. I will now turn the call over to Shawn who will provide additional insight into our 2016 results and our 2017 outlook. Shawn?

Shawn M. Guertin

Chief Financial Officer, Executive Vice President & Chief Enterprise Risk Officer, Aetna, Inc.

Thank you, Mark, and good morning, everyone. Earlier today, we reported full-year 2016 operating earnings of $2.9 billion, a 7% increase over 2015 and operating earnings per share of $8.23. Aetna's operating results represent solid earnings per share growth despite the lack of any share repurchases in the year and the significant pressure from our ACA-compliant products, continue to be supported by solid top line growth and operating margins, and are consistent with our long-term growth framework.

I'll begin with some comments on our full-year 2016 performance. From a top line perspective, we ended the year with 23.1 million medical members. We grew operating revenue by nearly 5% over 2015 to $63 billion, driven by higher health care premium yields and membership growth in our Government business and Large Group Commercial Insured products, partially offset by membership attrition in our Small Group and international Commercial Insured products. From an operating margin perspective, our portfolio of businesses performed quite well.

Our full-year pre-tax operating margin was 8.3%, a very strong result and consistent with our target operating margin range. Our full-year Total Health Care Medical Benefit Ratio was 81.8%, a better result than our previous projection. Our full-year adjusted operating expense ratio was 18.1%, an 80 basis point improvement over 2015. This year-over-year improvement speaks to our disciplined focus on managing our operating costs as we continue to grow our top line.

Looking at our fourth quarter results, operating revenue of $15.7 billion was steady versus the third quarter. Our pre-tax operating margin was 6.4% for the quarter, a 40 basis point improvement over the prior year quarter. Our Total Health Care Medical Benefit Ratio was 82.1%, a 20 basis point increase year-over-year. This result was better than our previous projections as medical cost trend remained moderate in the fourth quarter of 2016. Our adjusted operating expense ratio was 19.8%, a 70 basis point improvement compared to the fourth quarter of 2015 and consistent with our previous projections.

From a balance sheet perspective we remain confident in the adequacy of our reserves. We experienced favorable prior period reserve development in the quarter across all of our core products primarily attributable to third quarter dates of service. Days claims payable were 54 days at the end of the quarter, slightly down from the prior year quarter. Sequentially, this metric decreased three days, driven by the decreased claim processing times and the reduction of the premium deficiency reserve.

Turning to cash flow and capital, operating cash flows remained strong. Our full-year Health Care and Group Insurance operating cash flows were 1.4 times operating earnings and 1.8 times GAAP net income. We did not repurchase shares during 2016 as a result of the pending Humana acquisition. We did, however, distribute $88 million during the fourth quarter through our quarterly shareholder dividend, bringing our full-year distribution to $351 million.

In summary, we are quite pleased with the strength of our full-year results, as core operations were able to more than offset the drag from ACA-compliant products. I will now discuss the key drivers of our fourth quarter performance in greater detail.

Beginning with our Commercial fee based business, where our fourth quarter results capped off another strong year. We grew by 68,000 ASC members in the quarter, achieved positive fee yields, and generated solid year-over-year operating earnings growth. In our Commercial Insured business, our membership declined by roughly 139,000 members in the quarter, directionally consistent with our expectations. This change is the result of attrition in our Individual and Small Group membership, partially offset by growth of nearly 50,000 Large Group Commercial Insured members. Our Commercial Medical Benefit Ratio was 83% for the quarter, a result that was better than our previous projections. Underlying this result in the quarter was continued moderate medical cost trend in our core Large Group products and some improvement relative to our previous projections in our Small Group insured products.

Consistent with our fourth quarter MBR performance, we estimate that our full-year 2016 non-ACA Core Commercial medical cost trend was at the low end of our guidance range of 6% to 7%. Partially offsetting the fourth quarter out-performance in our group Commercial Insured business was the continued pressure in our Individual Commercial ACA-compliant products. Underlying medical costs and estimates of 3R reimbursements drove continued losses in the quarter pushing full-year pre-tax operating losses in our Individual ACA-compliant products to $450 million.

As you are aware, we have made changes to our footprint to reduce our risk exposure to these products for 2017. Based on our current view of open enrollment, we project our first quarter Individual Commercial membership will decline from approximately 965,000 members at year-end 2016 to 240,000 made up of mostly on-exchange members. Consistent with past years, there was a fair amount of churn in this product, resulting in approximately 50% of our Individual Commercial membership being new to Aetna. Given the high churn in membership combined with our fourth quarter experience and fixed cost deleveraging as we shrink our membership, we project losses on our Individual Commercial ACA-compliant products in 2017. However, we expect these losses to be meaningfully lower in 2017 as compared to 2016.

Shifting to our Government business, which had yet another strong quarter, we grew medical membership by 60,000 members in the quarter including growth of 16,000 Medicare members and 44,000 Medicaid members. As a result of strong medical membership growth throughout the year, we grew our fourth quarter 2016 government premiums by nearly 13% compared to the prior year period to $6.5 billion. Government premiums now represent nearly 50% of our total health care premiums. Our fourth quarter Government Medical Benefit Ratio was 81.2%, a very strong result driven by year-over-year improvement in Medicare.

Moving on to the balance sheet, our financial position, capital structure, and liquidity all continue to be very strong. At December 31st, we had a debt to total capitalization ratio of approximately 53.6%, which reflects the debt financing that we completed in June to fund the pending Humana acquisition. Looking at sources and uses of cash and investments at the parent, we started the quarter with approximately $2.3 billion, excluding funds raised from our June debt financing. Net subsidiary dividends to the parent were $317 million. We paid a shareholder dividend of $88 million, and after other sources and uses, we ended the quarter with approximately $2.2 billion of cash at the parent. Including the funds from the June debt financing, we ended the quarter with approximately $15.1 billion. Our basic share count was approximately 352 million at December 31st.

Shifting to 2017, this morning we provided an initial standalone 2017 operating EPS projection of at least $8.55. This guidance excludes the impact of prior year's reserve development. While we are still considering our options in an effort to provide as much transparency as possible, this guidance presents a standalone scenario assuming there is no Humana transaction. Our baseline view of Aetna's 2016 operating EPS of $7.77 reflects our 2016 operating EPS of $8.23 less 2016's prior year's reserve development of approximately $0.46. Our initial 2017 operating earnings projection of at least $8.55 represents at least 10% growth over this baseline view.

While there are many puts and takes in our initial outlook, our projected 2017 operating EPS growth off of our 2016 baseline reflects growth in Commercial Insured operating earnings led by a reduced level of losses on our Individual products, suspension of the health insurer fee, continued Medicare top line growth powered by continued strong growth in Individual MA, and the resumption of share repurchase activity. Partially offsetting these dynamics are a number of challenges in 2017 including the projected impact of the previously disclosed Medicaid contract losses and lower projected Group Insurance operating earnings.

Our 2017 operating EPS guidance is further influenced by the following drivers: We projected our first quarter 2017 membership will be in the range of 22.2 to 22.3 million medical members. This projection includes continued growth in our Medicare products of approximately 120,000 members and Commercial ASC membership growth of between 75,000 and 100,000 members more than offset by Individual Commercial declines of approximately 725,000 members related to previously disclosed changes to our footprint, Medicaid membership declines of approximately 150,000 members primarily associated with our exit of the Nebraska contract, Small Group

Commercial Insured declines of approximately 125,000 members reflecting our continued repositioning in these products. We project 2017 operating revenue to be in the range of $60 billion to $61 billion. This top line projection reflects our previously discussed ACA-compliant product decisions, the net impact of the previously disclosed Medicaid contract losses, and the suspension of the health insurer fee, partially offset by growth in our Government business, primarily Medicare products and higher premiums in our Large Group Commercial Insured products.

We project our 2017 non-ACA Core Commercial medical cost trend to be in the range of 6% to 7%, an approximately 50 basis point increase over 2016 at the midpoint of this range. This projection reflects an increase in health care utilization, partially offset by one less calendar day. We project our full-year Total Health Care Medical Benefit Ratio will be in the range of 84% to 85%, representing a 270 basis point increase at the midpoint of the range. This projected increase is driven primarily by the suspension of the health insurer fee, the exclusion of prior year's reserve development from our initial guidance, and experience rating pressure in our Group Commercial and Group Medicare Advantage products, partially offset by projected improvement in our Individual Commercial Insured products.

Our current view is that our full-year adjusted operating expense ratio will be 16.5% plus or minus 25 basis points, a 160 basis point improvement at the midpoint over 2016, primarily reflecting the impact of the 2017 suspension of the health insurer fee. Absent this impact, at the midpoint of this range, our operating expense ratio is projected to be essentially flat year-over-year, an excellent result given the previously disclosed revenue headwinds. We project our pre-tax operating margin to be approximately 8%, consistent with our high single-digit target with operating earnings of at least $2.9 billion. We project that net subsidiary dividends for the year will be approximately $2.9 billion. We project excess cash at the parent of approximately $4 billion after funding all Humana and Molina transaction-related fees and expenses.

In closing, I am very pleased with the strength of our fourth quarter and full-year 2016 results which exceeded our projections despite the challenges we experienced in our ACA-compliant products. As we begin 2017, the fundamentals of Aetna's business remain strong and we are confident that we can achieve our initial standalone 2017 operating EPS projection of at least $8.55.

I will now turn the call back over to Joe. Joe?

Joseph Krocheski

Vice President-Investor Relations, Aetna, Inc.

Thank you, Shawn. The Aetna management team is now ready for your questions. We ask that you limit yourself to one question so that as many individuals as possible have an opportunity to ask their questions. Operator, the first question, please.

QUESTION AND ANSWER SECTION

Operator: The first question comes from Josh Raskin with Barclays. Please proceed with your question.

Joshua Raskin
Analyst, Barclays Capital, Inc.

Q

Hi, thanks. Good morning, guys. Just want to drill into a little bit more the capital deployment expectation for 2017, I understand you're including share buybacks and I see share count down, just under 11 million shares, but when I think about your debt-to-cap and the $4 billion of total parent cash, it seems like a relatively modest amount of buybacks just relative to where you are and the fact that you haven't really bought back stock in almost two years. So, is there an intentional – are you intentionally leaving a little bit of wiggle room in terms of potential M&A and I understand you've got breakup fee to pay, et cetera, in the standalone case, but I'm just curious, any updated thoughts sort of in a standalone post-Humana world for capital deployment?

Shawn M. Guertin
Chief Financial Officer, Executive Vice President & Chief Enterprise Risk Officer, Aetna, Inc.

A

Yeah. So, Josh, a couple things. As you think about capital deployment, there's – in addition to share repurchase, there's one other thing that you need to think about that we have assumed here, and that is $2.7 billion of the deal debt is non-callable. So at some point, that will come back above the line, if you will, and we will have to bear the interest expense on that debt above the line. That's worth a little bit more than sort of a $0.10 item. But going back to the main thrust of your question, what I would say is we have largely assumed the $4 billion for the purpose of this guidance does go into repurchase. But the one area where we still have some uncertainty as we work through our final decision-making is the timing of that and the application of that throughout the year. So for this guidance we have assumed I think cautiously that that's more back-end weighted than it ultimately could turn out to be. But I think given where we are in the process, that's the prudent decision right now.

Joshua Raskin
Analyst, Barclays Capital, Inc.

Q

So, Shawn, just to follow up, $4 billion based on your current stock price would be with the understanding that even if you buy back late in the year, the 11 million, even if that doubles, it seems like, again, a real conservative assumption. So, I guess the question would be, would you be more aggressive and then have you guys thought about an accelerated buyback when you make your decision in the next couple weeks here?

Shawn M. Guertin
Chief Financial Officer, Executive Vice President & Chief Enterprise Risk Officer, Aetna, Inc.

A

Yeah, so what this would largely assume is that we would get to a debt-to-cap that would be between 35 and 40 by the end of the year. We may go a little bit higher than that. And certainly something like an ASR is on the table. Again, the timing of when we would pull the trigger on that is something that we're still working through as we work through sort of the final steps in our decision-making process.

Operator: The next question comes from the line of Justin Lake with Wolfe Research. Please proceed with your question.

Justin Lake
Analyst, Wolfe Research LLC

Q

Thanks. Good morning. So my question is around the go-forward on Humana. I'm just curious, given the length of time this has taken. We're two weeks past the judge's decision. Mark, can you just walk us through the moving parts that we should or the key points that we should be focused on here that will kind of drive your decision either way to appeal or not? And any comments on the potential divestiture package that could be required here, whether it could be above and beyond what you've laid out originally given the judge's opinion would be helpful.

Mark T. Bertolini
Chairman & Chief Executive Officer, Aetna, Inc.

A

Yeah. Justin, I think the way to think about it is that we have a merger agreement that goes till February 15. So we're going to take all of that time to make sure that we have pursued all potential opportunities to either appeal or not, and I think we're in the midst of that evaluation and we'll come to a conclusion before the [February] 15th. That's why we've given the kind of guidance we've given you. But you'll either see an announcement that we've terminated the deal or an extension, and I think we are in no rush given that we're literally two weeks away from having to make that decision to rush past any opportunities that we could consider.

Justin Lake
Analyst, Wolfe Research LLC

Q

Maybe I could ask you your opinion then, just in terms of the – the way the case has gone, obviously you're in a position to speak with a more sophisticated view than anybody else right now in terms of how the DOJ is viewing this stuff, and there's all kinds of iterations of where the world could go with or without Aetna and Humana being combined. I'm just curious in terms of the divestiture packages here that are – and how they were viewed. Is there anything you could tell us in terms of – is the DOJ just looking beyond now the potential to divest one-off membership in competitive counties and now looking for infrastructure behind that? Is there just a new way that they're looking at it that you think could be helpful for us to think about the go-forward world that we're living in now?

Mark T. Bertolini
Chairman & Chief Executive Officer, Aetna, Inc.

A

I think the one thing that we could say about our package and some of the criticisms that are in the opinion by the judge is that the DOJ is looking for sustainable competition. And I think that is their concern: Is there a management team, an infrastructure and an ability to remain in the markets, particularly in a retail product where people have a choice to select their products every year.

Operator: Our next question comes from the line of A.J. Rice with UBS. Please proceed with your question.

A.J. Rice
Analyst, UBS Securities LLC

Q

Hello, everybody. I would maybe ask about the Government business a little bit. First on the MA side, you had obviously a strong year, it seems like margin-wise. Are you at sort of your target margin, and is there assumption of margin stability in the 2017 outlook or further improvement there? And maybe any comment on your perception about the underlying market trends both in the Individual and Group business, have you seen a pickup versus what you were saying last year? Maybe I'll stop with that.

Mark T. Bertolini
Chairman & Chief Executive Officer, Aetna, Inc.

A

A.J., from the margin standpoint, we clearly have ended the year probably at the high end of our target margin ranges for both Individual and Group. So I don't view that further margin expansion is part of the future. And as you know, on group MA in particular, that is an experience rated arrangement, and when you have favorable experience as we've had, that actually tends to create some pullback on those margins. So – but I think the net story is that we are in that range now on Medicare, and margin expansion isn't part of the story.

On the Group MA, again, it – on the surface, our membership doesn't really tell the story of how strong the pipelines are on that product. I think as people know, we lost our largest Group MA account, and we still got close to breakeven again in terms of membership. And I think that speaks to the underlying strength of the pipeline and the interest in the value add of this product on behalf of employers and governments.

A.J. Rice
Analyst, UBS Securities LLC

Q

Okay. Any comment on the Individual market and the underlying – is your growth above market you think that you're seeing?

Karen S. Lynch
President, Aetna, Inc.

A

Yeah, A.J., I would say that we're quite pleased with the Individual growth. We believe that as we said earlier we'll be at 12%. We believe that's above market growth. We really are quite pleased with the result. We believe that it's reflective of our Stars performance. We have about a quarter of our membership growth coming from our expansion counties, and then we continue to be competitive in the rest of the counties across the country.

Mark T. Bertolini
Chairman & Chief Executive Officer, Aetna, Inc.

A

So, to fuel that growth, A.J., what we need to keep doing is expanding the number of counties that we're in, and depending on where we are with the Humana transaction, which we'll know here soon enough, accelerating our approach to market expansion is going to demonstrate some even further growth for us.

Operator: Our next question comes from the line of Matthew Borsch with Goldman Sachs. Please proceed with your question.

Matthew Borsch
Analyst, Goldman Sachs & Co.

Q

Yeah. I just wanted to ask a question on the Group Commercial – Group Commercial Insured pricing trends. So, I realize what we look at is not on a same store basis, but if we think about it on a same store basis, you price to a range something above a 6% to 7% trend for 2016. And I assume you're doing about the same for 2017. But if we looked at the pricing, would we see that it's 250 to 300 basis points lower for this year given the health insurer fee suspension?

Karen S. Lynch
President, Aetna, Inc.

A

Yeah. I think that you can consider about that, yes.

Matthew Borsch
Analyst, Goldman Sachs & Co.
Q

Okay. And just one other question on Individual enrollment. How did the 240,000 compare to what you expected? I know that was something that your guidance was riding on to a certain degree. And related to that, I thought that you were expecting most of the membership would be off-exchange. Did I get that wrong?

Karen S. Lynch
President, Aetna, Inc.
A

First of all, the membership in the Individual business was in line with our overall expectations. We were expecting that that membership would be primarily on-exchange. If you recall, our off-exchange strategy was to go dormant in a number of states, and that's what we did. So if you think about the 240,000 that we're projecting, think about 190,000 as on-exchange.

Matthew Borsch
Analyst, Goldman Sachs & Co.
Q

Thank you

Operator: Our next question is from the line of Kevin Fischbeck with Bank of America Merrill Lynch. Please proceed with your question.

Kevin Mark Fischbeck
Analyst, Bank of America Merrill Lynch
Q

Great. Thank you. I just want to take a step back and ask about the long-term growth. Because you said a few times that you feel really good about the long-term growth of the company. I think 2017 is kind of an unusual year given all the exchange exits and Medicaid contract losses, and I think that the question that I get most often is kind of how is Aetna positioned to grow over a long period of time. I would just love to kind of hear your broad thoughts about maybe each product, what you see that top line growth opportunity being and any color you can give there about long-term growth rate?

Shawn M. Guertin
Chief Financial Officer, Executive Vice President & Chief Enterprise Risk Officer, Aetna, Inc.
A

Okay, Kevin. Thanks, Mark. We first of all believe that Medicare and Medicaid will be growth markets for us and continue to be even in spite of our procurement losses in Medicaid, we still have a strong pipeline and have had good growth. And so we think we've got that figured out and worked through, and part of it was related to exchange departicipation.

So, I think we've worked our way through those issues. So, Government, clearly a strong growth market. In the Commercial market, underlying our results, if you pull out what happened with the exchanges we've had strong growth starting up for the first time in quite a while, and particularly around our Small Group AFA or alternative funding arrangement products. And in our Large Group business. So we feel good about the approach to our group market on the Commercial side. More importantly, though, I think as we see the evolution on this next step of health reform, there is an opportunity for a retail market that is much more stable than the ACA has been as a way for us to grow.

And so we are actively engaged in those discussions of understanding how we can preserve the good parts of the ACA but also bring forward ideas around funding mechanisms that stabilize the market for all the people in it and encourage younger people to get in. And more to come on that as we move ahead, but we think that's a strong opportunity and could move retail market in healthcare much faster than even people would assumed would happen with the Cadillac tax.

Kevin Mark Fischbeck
Analyst, Bank of America Merrill Lynch

Q

Okay. That's helpful. And I guess maybe also to that context, I think you mentioned Individual MA margins are about where they should be. If you look at the products and kind of say are you basically at target margins, is there room for opportunity in different products, or is there expectation of versus your 2017 guidance expectation for margins – tend to be up or down from those levels

---

Mark T. Bertolini
Chairman & Chief Executive Officer, Aetna, Inc.

A

It's a market-by-market approach, Kevin. So in some places we're approaching rebate status in Medicare Advantage Individual. And so in those cases, we have to evaluate how we price moving forward versus other markets where we're not where we need to be and have more opportunity particularly with our Star ratings. So I wouldn't categorize it across the board, but the margins are healthy, and we intend on trying to maintain those but in some markets it would be – wouldn't be productive for us to continue to push margins up because we'd just be rebating it back.

Operator: Thank you. Our next question is from the line of Dave Windley with Jefferies. Please go ahead with your question.

David Howard Windley
Analyst, Jefferies LLC

Q

Hi. Good morning. Thanks for taking my question. Could you talk, Mark, about providers' willingness to continue to enter into value-based purchasing or other types of more collaborative, strategic arrangements and then numerically looking at guidance around trend from last year to this year, you came in at the – from this time last year to now, you came in at the low end of your range, and it does appear that the gains that you made were on the price or on the unit cost side. And just wanted to kind of understand what the dynamics were in those areas.

Mark T. Bertolini
Chairman & Chief Executive Officer, Aetna, Inc.

A

Yeah, we continue to see more opportunities for value-based contracting. I think value-based contracting is going to continue to be encouraged by even the current administration as a way of getting a handle on healthcare costs. We have a healthy pipeline of opportunities. They will not all be joint ventures. I think there are other models emerging. But currently we have 45% of our medical spend in value-based relationships and continue to pursue reaching our 2020 goal of 75%, 80%.

So I think that is the set of numbers that we can rely on to further push down our healthcare costs over time by putting in these value-based relationships which not only work on unit costs but also very much work on providing high-quality care and reducing utilization over the long term as we noted in our readmission rates and in our reduction of in-patient days. So, I think that is a strong opportunity. In our current trends, we still see unit price as being a driver and less about utilization, and we see this year over last year at the mid-range, a 50 basis point increase in trend.

David Howard Windley
Analyst, Jefferies LLC

Q

Okay. Thank you.

Operator: Our next question comes from the line of Christine Arnold with Cowen and Company. Please proceed with your question.

Christine Arnold
Analyst, Cowen and Company LLC

Q

Hi there. Shawn, when you went through kind of the pluses and minuses, I think you said – tell me if I misunderstood – that you're expecting lower group operating earnings. First of all, did I get that right, and what might be driving that?

Shawn M. Guertin
Chief Financial Officer, Executive Vice President & Chief Enterprise Risk Officer, Aetna, Inc.

A

Yeah, the comment specifically was lower Group Insurance operating earnings, not Commercial group. I can let Karen comment a little bit about what's going on in that business.

Karen S. Lynch
President, Aetna, Inc.

A

Christine, there's two factors really. One, if you recall two years ago, we announced that we had a large national account loss. This next year is the continuation of one of the products in the Group Insurance line. The second reason is lower net investment income, and if you think about this business, we have long-term duration assets, and as they're maturing, they're coming off the books in a lower interest rate environment, although the interest rate environment is improving, if you think about it seven years ago, it was much higher. So you're just seeing the turn of assets around that driving lower net investment income but those are the two factors.

Christine Arnold
Analyst, Cowen and Company LLC

Q

Okay. It looks like you're looking for some pretty meaningful SG&A cuts. Is that permanent, or is that going to represent a headwind to 2018? How do we think about that?

Mark T. Bertolini
Chairman & Chief Executive Officer, Aetna, Inc.

A

No, as we have talked about this before, Christine, we've had a pretty concerted effort to sort of drive productivity gain, sustainable productivity gain. So, that's not something where there's anything meaningful in there that's one-time unique to 2017. This is really part of our ongoing approach to the business. And as we saw in 2016 in years where we grow, we usually get some tailwind from all of that productivity work. Obviously in a year where revenue is pressured, you're fighting the deleveraging aspects of that.

Christine Arnold
Analyst, Cowen and Company LLC

Q

Okay. Thank you.

Operator: Our next question is from the line of Gary Taylor with JPMorgan. Please proceed with your question.

Gary P. Taylor
Analyst, JPMorgan Securities LLC

Q

Hi, good morning. I just had a couple questions on the earnings bridge, I want to make sure I understood it. One of them was around Group Insurance, and I think we just covered that. But is that primarily group disability? Would that be the primary product we're talking about?

Karen S. Lynch
President, Aetna, Inc.

A

Okay. Group disability and life is in the Insurance line but it is relative to the disability business.

Gary P. Taylor
Analyst, JPMorgan Securities LLC

Q

Yeah, and then on the HHS suspension, Shawn, I just wanted to understand that. I guess if we just look at the MA business alone, we think there's close to $0.60, but we were only estimating perhaps $0.20 with flow through net of your below trend 2017 rate increase from MA. So that $0.10, is that a net number incorporating the rate increase you receive from MA, or how do you get that?

Shawn M. Guertin
Chief Financial Officer, Executive Vice President & Chief Enterprise Risk Officer, Aetna, Inc.

A

The simplest way to think about it is that the $0.10 is, quote, the early recovery of the 2018 HIF as we work that into pricing. So that's largely a Commercial concept for 2017 because most of the Government business is on a one-one. So, that's really what that represents.

Gary P. Taylor
Analyst, JPMorgan Securities LLC

Q

And in the MA business, there's not an assumption some of that lower G&A would flow through to earnings?

Shawn M. Guertin
Chief Financial Officer, Executive Vice President & Chief Enterprise Risk Officer, Aetna, Inc.

A

No. I mean, we have largely in our bids given where our margin profile is, any relief, if you will, from the HIF for 2017 has been largely incorporated into benefit design. I think you probably can see that to some extent in our strong growth in Individual. But it's really not a meaningful margin concept for MA for us.

Gary P. Taylor
Analyst, JPMorgan Securities LLC

Q

Okay. Great. And then last part on the capital deployment, could you just repeat I think what you had said to earlier, but you had said – I thought I had heard a $4 billion number and I wasn't sure that I heard that right, on the $0.18.

Shawn M. Guertin
Chief Financial Officer, Executive Vice President & Chief Enterprise Risk Officer, Aetna, Inc.

A

Yeah, so what we said in the prepared remarks is that we anticipate after we settle termination and deal-related expenses that we would have $4 billion of parent cash to deploy. That is inclusive of some non-callable debt that we will bring above the line in that circumstance so there will be some added interest rate expense that comes with that. So, but $4 billion is the gross number

Operator: The next question comes from the line of Scott Fidel with Credit Suisse. Please proceed with your question.

Scott Fidel
Analyst, Credit Suisse Securities (USA) LLC (Broker)

Q

Thanks. Shawn, I'm wondering if you can just give us some more details on some of the margin assumptions within Individual and Small Group and sort of the roll forward from 2016 and 2017. So I guess first on Individual, sort of the margin losses basically built into 2016 and then what you're assuming on the lives for 2017 and then similarly on Small Group and within Small Group, it sounds like you ended up doing a little bit better in the fourth quarter on margin, so maybe what Small Group margins ended up being in 2016 and what you're assuming for 2017.

Shawn M. Guertin
Chief Financial Officer, Executive Vice President & Chief Enterprise Risk Officer, Aetna, Inc.

A

Yeah, so on Individual, obviously we had a very poor margin result in 2016, and we anticipate, as I mentioned, that we'll continue to lose a meaningful amount in 2017 but not as much. One way to think about that is if you looked at our earnings bridge and you thought about the $0.75 that's identified there for core growth and Individual improvement, somewhere in the ballpark of two-thirds of that is probably driven by the Individual business, and that will give you from a $450 million loss some sense of at least where we stand today for guidance purposes. Small Group actually did improve 2016 actually versus 2015. We definitely – we actually saw favorability in Commercial across all segments, but it was nice to see in Small Group. This is really a repositioning story, as you know we continue to have some insured markets where the ACA business is pressured, we will likely continue to lose membership in those markets in 2017. And as Mark alluded to, we have some alternate funding products that are selling in here, and those will have a bit of a difference. So at the end of the day, I don't think that Small Group itself is a big part of the earnings move from year to year. It continues to be a repositioning year for us for that segment.

Karen S. Lynch
President, Aetna, Inc.

A

And I think it's important to note on the Small Group, we've really done a repositioning of the products with this self-insured. We are seeing very strong market receptivity relative to our offering. We have introduced differentiated products with our Visa capabilities, and we're quite pleased with the results in our alternative funding products.

Scott Fidel
Analyst, Credit Suisse Securities (USA) LLC (Broker)

Q

So, basically does that sound like Small Group margins may be getting to that sort of low single-digit range again in 2017? And really what I'm thinking about is, as we go through the healthcare re-reform process, if we ended up getting regulatory relief around a lot of the ACA mandates that pressured Small Group margins, how much potential – basically where were Small Group margins maybe even before ACA, and is there potential for sort of the re-reform process to provide some substantial relief on the Small Group margin side?

Shawn M. Guertin
Chief Financial Officer, Executive Vice President & Chief Enterprise Risk Officer, Aetna, Inc.

A

I mean, I think over time, that's certainly a possibility. I mean we've always viewed this somewhat as like a mid single-digit insured sort of pre-tax margin business, and we clearly haven't been there. So I think over time, there is that potential. But as Mark alluded to, there's a lot that has to play out here in both Individual and Small Group, I think, before we could take a lot of comfort that that's coming.

Mark T. Bertolini
Chairman & Chief Executive Officer, Aetna, Inc.

A

Scott, I think one of the issues we need to be careful about is now we have three different pools of risk in the Small Group market. We have the keep-what-you-have market, which are people who are underwritten with old plans. We have the alternative funding market, which are people who have decided not to be insured and take advantage of different funding mechanisms. And then we have people who are in the ACA, and how that sorts out based on this new version of reform, the replace initiative, is going to be a delicate and interesting balance. And probably won't really happen much before 1/1/2019 quite frankly.

Scott Fidel
Analyst, Credit Suisse Securities (USA) LLC (Broker)

Q

Okay. Thanks.

Operator: Our next question is from the line of Sarah James with Piper Jaffray. Please proceed with your question.

Sarah E. James
Analyst, Piper Jaffray & Co. (Broker)

Q

Thank you. I wanted to clarify your comment on evaluating options post Judge Bates' feedback on the sustainable competition aspect. Does that imply there's some flexibility in an appeal process where you could change up the acquirer of divestitures?

Mark T. Bertolini
Chairman & Chief Executive Officer, Aetna, Inc.

A

I think we're way too early in the process to have that kind of conversation. We're still working through. It's been eight days since we received the ruling. It took a few days to read it and understand it to a level of depth necessary to consider our next moves, and we're in the process of making all those next moves now. So I would want to wait until we have a full evaluation of our opportunities and alternatives.

Sarah E. James
Analyst, Piper Jaffray & Co. (Broker)

Q

Got it. So it's not laid out in the existing contract that it has to be one way or the other?

Mark T. Bertolini
Chairman & Chief Executive Officer, Aetna, Inc.

A

There is no – there is no existing contract other than the agreement we have with Molina and the agreement we have with Humana that would address that issue right now.

Operator: Our next question comes from the line of Peter Costa with Wells Fargo. Please go ahead with your question

Peter Heinz Costa
Analyst, Wells Fargo Securities LLC

Q

Good morning. Your components of cost trend guidance for 2017 are the same as they were for 2016, yet you changed up the mix of utilization versus unit cost a little bit. And you also came in at the lower end of those costs coming in at 6% or so as opposed to 6% to 7%. Can you tell us where the savings were and why you're projecting the same thing going forward into 2017?

Shawn M. Guertin
Chief Financial Officer, Executive Vice President & Chief Enterprise Risk Officer, Aetna, Inc.

A

Well, what I would say – and this will ultimately take greater shape and improved clarity as the quarter matures, but generally as the year goes on, we have good insight into unit cost. So, variations in trend tend to be updates on utilization. I know for example in the fourth quarter we had a couple of good months, anyway, of pharmacy experience in the fourth quarter. But generally these will usually play out as improvements into the utilization baseline. The outlook is a fairly detailed process we go through, sort of category-by-category looking at contracts, looking at the trends that we see. And, sometimes those end up with the same number, but the pathway there obviously looks different from year to year. I mean, I think, we continue to assume that we see a modest uptick in trend from year to year as we have, and that's continued to be our go-forward pricing position.

Peter Heinz Costa
Analyst, Wells Fargo Securities LLC

Q

Can you talk about your PBM arrangement currently, and what you plan to do there and why that's triggering low double-digit growth in pharmacy spend?

Mark T. Bertolini
Chairman & Chief Executive Officer, Aetna, Inc.

A

Well, our current PBM relationship is in place until 1/1/20, and so we continue to work with CVS on finding ways to address our costs. I think our double-digit trend is really related to Specialty Pharmacy for the most part, which I think is plaguing everybody, and that's a place where we're both focusing both CVS and Aetna on how we can improve that.

Operator: Our next question is from the line of Lance Wilkes with Sanford Bernstein. Please proceed with our question.

Lance Arthur Wilkes
Analyst, Sanford C. Bernstein & Co. LLC

Q

Yeah. I've got a question on your long-term growth opportunities and really thinking less about the products, I'm thinking more about some of the underlying margin opportunities or beyond products. So, I was interested in an update on Healthagen status and the outlook for that. Is it really just driving membership growth, or do you see that as a standalone margin opportunity? And then also on the international side, if you see any further growth either inorganic or organic there?

Mark T. Bertolini
Chairman & Chief Executive Officer, Aetna, Inc.

A

Well, on the Healthagen side, it's still running full speed ahead, building more joint ventures, but I think as we look at that business and as we evolve through the next year or so, we will see it as much more of a standalone entity with its own standalone margin. But we very much want to make sure it's linked to the leverage inside our business in managing medical costs and bringing underwriting margin into Aetna the insurance company. So that's very much an important part of our relationship. And we will reward that organization and its leadership on that basis. So, with Gary Loveman now in the lead there and building new products and new insights into products as well as markets and individuals in the retail marketplace, we will hold Healthagen accountable for helping us deliver lower medical costs but also generating its own margin for its business and including however we go forward with CVS on our PBM relationship.

So, good organization, strong organization, great opportunity for us, doing well. They will not all be joint ventures, as I mentioned earlier. We will be looking at various other methods for getting value-based contracting across our book of business.

Lance Arthur Wilkes
Analyst, Sanford C. Bernstein & Co. LLC

Q

Good, and also will you be looking at any sort of acquisitions of physician practices, kind of alternate site delivery, or do you see that as in conflict with providing services to some of those sorts of organizations?

Mark T. Bertolini
Chairman & Chief Executive Officer, Aetna, Inc.

A

We see a huge opportunity of being in the community and in the retail marketplace as a way of delivering care to the home, and so I think we're going to focus more on that model versus the current structure of the hospital and particularly specialist physician marketplace. So we see opportunity in keeping people at home, getting as much care to the home as possible through either contingent or contracted workforce or our own employees, and then using local community resources and retail locations as a way of backing up the home-provided care. So, those are the areas we'll be looking.

Operator: Our next question is from the line of Michael Newshel with Evercore. Please proceed with your question.

Michael Newshel
Analyst, Evercore Group LLC

Q

Hello, thanks. Good morning. Can you walk us through your thinking and the timeline for making decisions on participation in the Individual market in 2018 and what do you need to see from Congress and when do you get enough clarity to remain in the markets that you're remaining in for 2017?

Mark T. Bertolini
Chairman & Chief Executive Officer, Aetna, Inc.

A

We have no intention of being in the market for 2018. Currently where we stand, we'd have to have markets worked up, prices worked up for April 2017 in order to apply, and there is no possible way that we'll be prepared to do that given the unclear nature of where regulation's headed. We will, however, participate where we think it's appropriate in 2018 as we currently evaluate our performance in helping support the transition to whatever comes forward in 2019 or 2020.

Michael Newshel
Analyst, Evercore Group LLC

Q

Great, thanks. And maybe just one quick follow-up just to clarify on cost trend. Is that 6% to 7% forecast, is that adjusted for the fact that 2016 is a leap year and there's one fewer day in 2017?

Michael Newshel
Analyst, Evercore Group LLC

Q

We haven't made any specific adjustments for that in that trend.

Operator: Our final question is from the line of Michael Baker with Raymond James. Please proceed with your question.

Michael J. Baker
Analyst, Raymond James & Associates, Inc.

Q

Yeah, thanks a lot. Mark, I was wondering if you could comment and add a little bit more color on the services business. You indicated that key focus is care in the home. I was wondering if you can touch on other elements as well as we're starting to see other players in healthcare leverage data. I know historically that's kind of been an area of focus for you. Are there certain moves or plans around that part of your business going forward?

Mark T. Bertolini
Chairman & Chief Executive Officer, Aetna, Inc.

A

Definitely there is. Under Gary's leadership, we have built up our data analytics department rather dramatically and are starting to come to some real interesting insights that have already begun to help us on our medical costs, on our sales, and on our underwriting margin. So we continue to see that as an area of focus and an area of investment for the company. As we have evaluated where we go without doing the Humana transaction, we had made priority decisions around again leveraging data analytics, leveraging in the home care and services as a way of impacting our medical cost and our growth and our quite frankly our retention of customers particularly in the Medicare space as an opportunity for us to move ahead. And so we will – you will see more investments in the services business as we move head.

Michael J. Baker
Analyst, Raymond James & Associates, Inc.

Q

Thanks.

Joseph Krocheski
Vice President-Investor Relations, Aetna, Inc.

Thank you, Mike. A transcript of the prepared portion of this call will be posted shortly on the Investor Relations section of aetna.com, where you can also find a copy of our updated guidance summary including details of our guidance metrics including those that were not discussed on this call. If you have any questions about matters discussed this morning, please feel free to call me in the Investor Relations office. Thank you for joining us this morning.