Q1 2016 Aetna IncEarnings Call - Final

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Presentation

OPERATOR: Good morning. My name is Christine and I will be your conference facilitator today. At this time, I would like to welcome everyone to Aetna's first-quarter 2016 earnings conference call.

(Operator Instructions)

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.

JOE KROCHESKI, VP OF IR, AETNA INC.: Good morning and thank you for joining Aetna's first-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 currently projected results are described in this morning's press release and the reports we file with the SEC. We have also provided reconciliations of certain non-GAAP measures in our financial supplement and guidance summary. These reconciliations 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 non-public 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 BERTOLINI, CHAIRMAN AND CEO, AETNA INC.: Good morning. Thank you, Joe, and thank you all for joining us today. This morning, Aetna reported first-quarter operating earnings of $2.30 per share. A good start to the year and a continuation of the strong momentum from 2015, where we generated record annual operating revenue and operating earnings.

Underlying our first-quarter performance we exceeded our previous membership projections, ending the quarter with approximately 23 million medical members. We grew operating revenue to a quarterly record of $15.7 billion. We achieved pretax operating margins at the high end of our targeted range, and we generated approximately $1.8 billion in operating cash flow.

Given our strong start to 2016, today we made several adjustments to our full-year 2016 guidance. We established a year-end medical membership projection of approximately 23 million members. We now project we will generate up to $63 billion of operating revenue, up from our previous projection of approximately $62 billion, and we increased our operating EPS projection to a range of $7.90 to $8.10 per share, up from our previous projection of at least $7.75.

In a few moments, Shawn will discuss our first-quarter results and updated 2016 guidance in greater detail. But first, I would like to provide a brief update on the Humana acquisition and discuss some of the operational

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highlights for the quarter. Beginning with the Humana acquisition, our integration teams are thoughtfully planning for a combined organization that delivers on our synergy and accretion goals, and maximizes the transformational nature of this combination.

We continue to cooperate with the Department of Justice and work with state regulators, and now have approvals in six states remaining. Based on our progress to date, we believe we remain on track to close in the second half of 2016.

Moving on to first-quarter operational highlights. We had another strong quarter of growth in our Medicare business, with membership growth across all products. Our compelling product design and industry-leading star ratings continue to resonate with Medicare consumers, as evidenced by our 9% sequential individual MA membership growth, which once again exceeded overall Medicare Advantage program growth. In total, including Medicare supplement, we have grown to serve 127,000 additional Medicare medical members in the first quarter, capping another strong annual election period for the Company.

Medicare Advantage remains an important growth lever for Aetna, and we are encouraged by the relative stability and funding for the 2017 plan year.

However, we are concerned with a few of the changes outlined in the 2017 final rate notice, including the rate cuts to the Employer Group Waiver program and the potential disruption in benefits for the millions of beneficiaries who rely on this important program. This is particularly concerning in 2018 when the rate cuts are fully phased in.

We will continue to work with CMS to refine the employer group payment methodology for 2018 to appropriately reflect the differences between employer group and individual plans. Additionally, CMS changes to the MA star ratings program and risk-adjustment mechanism for dual-eligible beneficiaries add unnecessary complexity to star ratings and instability in the risk-adjustment program. Despite the challenges posed by the group MA payment changes, we remain committed to providing value to our employer customers by delivering high-quality, affordable options for their retirees.

Continuing on with our government business. Our Medicaid franchise delivered another quarter of solid revenue growth and underwriting margin performance. Aetna now serves over 2.3 million Medicaid members, an increase of nearly 230,000 from the same period a year ago. This steady growth has been driven by a combination of new contract wins, county expansions in existing states, and ACA-related expansion membership.

Looking to the future, we are confident that Aetna is well positioned to take advantage of the strong growth dynamics of the Medicaid business, as more states seek to partner with the private sector, to manage the health of their Medicaid beneficiaries.

Let me take a moment to discuss public exchanges in our individual business. From a regulatory perspective, we welcome the efforts of CMS to work with the industry to stabilize the individual public exchange program. While we are encouraged by these regulatory efforts, there is still much work to be done to ensure the long-term future of this program. As we enter the third year of the public exchange program, we are committed to working constructively with the administration and lawmakers to find solutions that can improve this program, stabilize the risk pool, and expand product flexibility, all with the goal of creating a sustainable program that makes health care more affordable and accessible for all consumers.

Turning to our first-quarter individual commercial results, we ended the first quarter with approximately 1.2 million total individual members, exceeding our previous membership projection. The overall demographic composition of our membership is largely consistent with last year and our expectations. While it is still early, we are encouraged by our year-to-date performance and believe we remain on track to achieve our 2016 operating margin improvement goals in these products.

Finally, our stated mission is to create a healthier world. Our strategy to achieve this mission, in part, involves working to transform the health care system model to one in which hospitals and doctors are rewarded for delivering real value to patients and consumers.

Our differentiated approach focuses on meeting providers where they are in terms of their readiness for varying levels of coordinated care and risk. We are applying our proven framework to support the advancement of value-based care models and move providers up the continuum, from simple pay-for-performance models to ACOs and even joint ventures.

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We've made good progress in the first quarter and now have 77 ACO agreements and approximately 40% of our claims payments running through some form of value-based care model. Based on our progress to date, we believe we remain on track to achieve our 2020 goal of 75% of claims in value-based care models, and our broad mission of creating a healthier world.

In summary, we are off to a good start to 2016. I want to thank our employees for their efforts in delivering another strong quarter for Aetna and our shareholders. With the momentum from the first quarter, I am confident we have the right vision to lead in a changing health care marketplace, we can continue to execute on our differentiated strategy, we will successfully close and integrate a proposed Humana acquisition, and we can achieve our 2016 operating EPS projection of $7.90 to $8.10.

I will now turn the call over the Shawn, who'll provide additional insight into our first-quarter results and our updated 2016 outlook. Shawn?

SHAWN GUERTIN, CFO, AETNA INC.: Thank you, Mark, and good morning, everyone. Earlier today, we reported first-quarter 2016 operating earnings of $811 million and operating earnings per share of $2.30. Aetna's operating results continue to be supported by strong cash flow and operating margins. I'll begin with some comments on overall performance.

Our medical membership of 23 million is approximately 200,000 higher than the top end of our previously projected range, driven by lower ASC losses and higher individual membership growth. We grew operating revenue by 4% over the prior year to a record quarterly level of $15.7 billion, driven by higher health care premium yields and membership growth in our government business, partially offset by membership declines in our group commercial insured products.

From an operating margin perspective, our businesses are performing quite well. Our pretax operating margin was 9.5%, a very strong result and consistent with the high end of our target operating margin range. Our first-quarter total health medical benefit ratio was 80.5%, a strong result that benefited from continued moderate medical cost trends and favorable prior-year's reserve development. Our operating expense ratio was 18%, a 40 basis-point improvement over the first quarter of 2015, and a good start to achieving our operating cost goals for the year.

From a balance sheet perspective, we remain confident in the adequacy of our reserves. We experienced favorable prior-year's reserve development in the quarter across all of our core products, primarily attributable to fourth-quarter 2015 dates of service.

Our reserve growth exceeded our premium growth, and days claims payable were 57 days at the end of the quarter, a sequential increase of approximately two days. The increase in days claims payable was primarily a result of increased processing times, which we expect will normalize over the remainder of the year.

Turning to cash flow and capital, operating cash flows in the first quarter were strong. Health Care and Group Insurance operating cash flows were approximately 2.3 times operating earnings, driven by strong operating results and the timing of certain ACA-related payments in the quarter.

We did not repurchase any shares during the quarter due to the proposed Humana acquisition. However, we did return $87 million to shareholders through our quarterly shareholder dividend.

In short, we are pleased with our first-quarter results and the continued successful execution of our growth strategy. I will now discuss the key drivers of our first-quarter performance in greater detail.

Beginning with our commercial business, our commercial ASC membership declined by approximately 660,000 members during the quarter, a disappointing result in absolute terms but an improvement relative to our previous projections. This improvement was driven by increased sales and higher retention rates, a testament to the actions taken to mitigate known customer losses.

From an operating earnings perspective, first-quarter commercial ASC results were a continuation of the strong momentum from 2015, primarily due to strong fee yields. In our commercial insured business, we grew membership modestly in the quarter, largely the result of higher individual membership, partially offset by lower small group and international membership.

Our commercial medical benefit ratio was 77.8% for the quarter, a good result that benefited from moderate medical cost trends, and favorable prior-year's reserve development. Based on first-quarter results, we continue to project that our 2016 core commercial medical cost trends will be in the range of 6% to 7%.

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With respect to our individual commercial business, we are off to a solid start to the year. At 1.2 million members, our first-quarter medical membership exceeded our previous projections, primarily related to on-exchange membership growth. And underwriting margins were largely consistent with our expectations, driven by favorable reserve development and stable estimates of 3R accruals.

Looking ahead to the balance of 2016, we expect that our first quarter will mark the high for our individual membership, as we project material attrition through the remainder of the year and a lower level of special election-period enrollment compared to prior years. Based on our first-quarter results, including updated reconciliation estimates for ACA programs, we believe we are on track to achieve our projected 2016 margin improvement goals for these products.

Shifting to our government business, which continues to be a key source of growth for the Company. We grew medical membership by nearly 150,000 members in the quarter, including growth of 81,000 in Medicare Advantage, 46,000 in Medicare Supplement, and 22,000 in Medicaid members. Additionally, we grew Medicare PDP membership sequentially by over 470,000 members.

As a result of this strong medical membership growth, we grew our first-quarter 2016 government premiums by over 13% compared to the prior-year period, achieving a record $6.5 billion. Government premiums now represent nearly 50% of our total Health Care premiums. Our government medical benefit ratio was 83.4%, a continuation of the outstanding results achieved in this business in 2015 and a very good start to the year.

Moving on to the balance sheet, our financial position, capital structure, and liquidity all continued to be very strong. At March 31st, we had a debt to total capitalization ratio of approximately 32%, as we continue to build cash ahead of closing the Humana acquisition.

Looking at cash and investments at the parent, we started the quarter with approximately $420 million. Net subsidiary dividends to the parent were $715 million. We paid a shareholder dividend of $87 million, and after other uses, we ended the quarter with approximately $970 million of cash at the parent. Our basic share count was approximately 351 million at March 31.

As a result of our first-quarter performance, we are increasing our 2016 operating earnings-per-share guidance to a range of $7.90 to $8.10 per share. The top end of this range represents a $0.35 increased relative to our previous projection of at least $7.75 per share, and reflects our favorable first-quarter operating performance, including the effect of favorable prior-year's reserve development and improved results in our fee-based businesses.

However, certain risks remain that temper our outlook at this point in the calendar, including, the ever-present concern that medical cost trends could increase more than we have projected, and low visibility at this juncture of the year into our ability to achieve our margin-improvement goals in our ACA compliant products, particularly the uncertainty related to accruals associated with the 3Rs.

Our updated 2016 guidance is influenced by the following additional drivers. Based on our first-quarter membership results, we project that our year-end medical membership will be approximately 23 million members, as growth in government membership over the remainder of the year is largely offset by declines in commercial insured membership, including attrition in our individual products.

As we consider the stronger-than-projected start to the year in our current membership view, we are increasing our operating revenue projection for the year and now project that we will deliver up to $63 billion in 2016 operating revenue. We continue to project that our full-year total medical benefit ratio will be in the range of 81.6% plus or minus 30 basis points. We continue to project that our operating expense ratio will be less than 18.5% for the full year.

We now project pretax operating margin to be 8% to 8.5%, consistent with our high single-digit target. We now project operating earnings of approximately $2.8 billion, and we now project excess cash flow to the parent of up to $2.4 billion, reflecting our Vitality Re VII reinsurance transaction, partially offset by increased capital requirements as a result of our higher premium growth projections. Finally, as we consider the progression of earnings for the remainder of the year, we expect our operating EPS to be more evenly balanced between the first and second half of the year as compared to 2015.

In closing, we are encouraged by the strength of our first-quarter results and our improved 2016 outlook, particularly at this early stage in the year. Further, we continue to believe we are on track to close the Humana acquisition in the second half of 2016 and achieve our 2018 combined Company operating EPS goal of at least $11. I will now turn the call back over to Joe. Joe?

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JOE KROCHESKI: 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.

Questions and Answers

OPERATOR: Josh Raskin, Barclays.

JOSH RASKIN, ANALYST, BARCLAYS CAPITAL: Hi, Thanks. Good Morning. Just want to delve into cost trends. There seems to be a little bit of a debate brewing. We're seeing pretty good numbers from some of the facility companies and med-tech companies, et cetera. And it sounded like everything you said was favorable development, cost trends remained modest, confirming the full-year, so it doesn't seem like you're seeing it. What do you think is causing some of that disconnect? Is it simply leap year and weather, or where do you stand on this utilization? Is there really any fundamental increase going on?

MARK BERTOLINI: Well Josh, we're not seeing an increase on the facility side at all. As a matter fact, we continue to see a trend downward in facility day usage. And so our view would be that this is probably related to a few instances, most likely related to flu and maybe leap year. Leap year has always been a mystical thing for me, one day added actually makes a difference, but it does. But we're not seeing it at all in our numbers.

SHAWN GUERTIN: Josh, and I would add the real issue here is what did we assume in pricing versus what we actually experienced. And for example, last year, trend was up, but we had assumed that in our forward pricing and so we were okay. We came into this year with a 50 basis-point increase in our forward pricing, so that's in the system. We've booked first-quarter consistent with that as well.

Again, I think this does come back to the match between your pricing assumption and what you see in the marketplace, because certainly over the last year or two, trend has been going up. And I would emphasize Mark's point about, it sounds funny sometimes to talk about leap year. But it is a real phenomenon when you do have an extra week day in a quarter, it obviously does make enough of a difference to show up.

JOSH RASKIN: Is that 80 basis-points on the MLR seem like a reasonable leap year estimate?

SHAWN GUERTIN: Yes, our internal estimates are a little bit lower than that. But it's all about whether this is weekday driven or calendar-day driven in terms of the range that you would look at this.

JOSH RASKIN: And then just a quick follow-up, Shawn. Your last comment on first half versus second half EPS, I think you're implying it's a midpoint of guidance, something around 170 in EPS for the second quarter, if it's really 50, 50. What's causing this additional seasonality? Why is more of the earnings back-end loaded this year?

SHAWN GUERTIN: No, okay, I'm glad you asked. Because that's -- the first half will definitely be over 50% as it has been in the year. My commentary there was just to indicate that it's going to -- as a percentage, first half will be down a little bit from the first half last year based on our internal forecast.

JOSH RASKIN: Okay, so 1% or 2%, not necessarily a 50-50 split now.

SHAWN GUERTIN: Exactly.

OPERATOR: AJ Rice, UBS.

AJ RICE, ANALYST, UBS: Thanks. Maybe just to ask about your government business. The MLR in the quarter was up, and you are pointing to lower prior-year development. There's also the fact that your Part D business grew dramatically, and my understanding is that can be a drag in the first quarter that then turns into a positive as the year progresses. Then you also have leap year on the government side. Were those less of a factor than what happened in prior-year development?

And maybe while we are on it, my follow-up would be on the government side. You guys are doing very well in the MA enrollment so far, but the overall market has been a little bit soft. Any thoughts on what's happening in the broader market out there in MA?

SHAWN GUERTIN: I'll let Mark talk about the MA outlook for the industry, but you're right. You've really canvassed the multiple factors that are impacting the government MBR. Specifically on PYD, we had talked last year and actually the year before that, that a lot of the higher than typical PYD we've gotten has been showing up in the government business. And we did expect that to reset to more normal levels this year, and indeed that is what we've seen.

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Again, on Medicaid specifically, we've been talking about the Kentucky rate reset, which has an MBR perspective. And you talked about both leap year and Part D. So we did expect this to go up. And again, I think at 8034, it's a very good result and one very consistent with our expectations.

MARK BERTOLINI: And AJ, as it relates to the MA outlook, I think what we continue to see is that in the retiring population, 11,000 Americans a day, still 68% of the population is electing for Medicare fee for service. And a large part about that is network construction, but most importantly, mobility. We see that as an opportunity, as we get to closing the Humana acquisition where we have the opportunity to create a nationally portable product, as we will be able to touch a much larger swath of the Medicare-eligible population across the United States.

AJ RICE: Okay. Thanks a lot.

OPERATOR: Gary Taylor, JPMorgan.

GARY TAYLOR, ANALYST, JPMORGAN: Just a few quick ones. First, could you give us the actual on-exchange individual enrollment for the first quarter?

MARK BERTOLINI: It's 911,000.

GARY TAYLOR: Okay. Thank you. And then, Shawn, just wanted to think a little bit more about the prior-year development. Obviously, you've disclosed the gross impact of that. But over the course of the quarters of 2015, you were also giving some color on the net impact, and I think we had estimated maybe roughly $0.40 of net benefit in the first quarter of 2015. Would you comment on 2016 and would you alter my first-quarter 2015 thought in any way?

SHAWN GUERTIN: That's in the neighborhood of being correct. For first-quarter 2016, it's between $0.30 and $0.35, probably closer to $0.30. It's the thing that we net against that obviously is the amount of any PYD that goes right back up in minimum loss-ratio accruals. That was a little higher this year just in terms of how the PYD fell, but you can think about $0.30 -- $0.30 to $0.35 as a range for this year.

GARY TAYLOR: Is it fair to say commercial PYD may be developed better than your expectation? I know you had anticipated PYD would be less of a net benefit in 2016. You talked about there was a little bit less on the government side. But overall, this is fairly similar, so it sounds like maybe commercial actually ended up a little better.

SHAWN GUERTIN: Commercial is just a little bit better in aggregate PYD year over year, but it's in the same neighborhood and a typical neighborhood. The decrease is really in the government business.

GARY TAYLOR: Got it. My last question. On Medicaid, with the Pennsylvania re-procurement out yesterday, it looks like you lost some regions and we're kind of sizing roughly $1 billion revenue impact for 2017. Is that in the ballpark?

KAREN LYNCH, PRESIDENT, AETNA INC.: As you know, they came out. We are disappointed a bit, and that is approximately the revenue for Pennsylvania. So that is pretty close.

GARY TAYLOR: Thank you.

OPERATOR: Peter Costa, Wells Fargo.

PETER COSTA, ANALYST, WELLS FARGO SECURITIES, LLC: I'm wondering if you can help us understand how value-based contracting is changing some of the dynamics around what we see as normalized trend and what you might see as normalized cost trend. And, if it varies by the different business categories, commercial, Medicare, or Medicaid?

MARK BERTOLINI: Peter, I would say, if you've seen one value-based contract you have seen one value-based contract. I think it's a pretty general definition. So they go everywhere from contracts that pay for better performance without any downside risk, to all the way to contracts where we are actually sharing risk top and bottom with providers. And I would say the closer we get to the latter structure, the more impact we have on utilization. And so in our relationships where we have that, we see definite impacts on underlying trend and utilization, where the provider actually wins by providing a more focused quality of care and generates margin out of the contract based on that.

Now I would also give another factor, which is between commercial and government, the numbers obviously in government are much larger from the standpoint of premiums, so there's more to share there. And so therefore,

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you have a lot more opportunity in the government sector. So we always like to lead with Medicare. Medicaid-duals is still a fuzzy area; we're still working through and understanding what the dynamics are there. And commercial is generally lower on the totem pole from the standpoint of risk-share opportunity as you move into those contracts.

PETER COSTA: And would you say that it's causing some of your utilization to become more concentrated with certain providers that perhaps do these contracts? Like perhaps some of the more publicly traded companies on the provider side that we see?

MARK BERTOLINI: Not quite yet. I don't think we have that much of an impact yet. I think still what we're seeing in trend moderation is the impacts in the economy on individuals and their out-of-pocket expense. $400 out of the average American to cover for services is a lot of money.

PETER COSTA: Okay. Thank you.

OPERATOR: (Operator Instructions)

Matthew Borsch, Goldman Sachs

MATTHEW BORSCH, ANALYST, GOLDMAN SACHS: I was hoping maybe you could give us a little bit more detail on your individual book in the exchange lines. I've heard you say 911,000 on exchange. I apologize, just off my fingertips, I don't have the year-end number for 2015. But also 1.2 million for your overall individual book versus I think about 1 million at year end. So is it about 200,000 and where do the new members -- where do you think they are coming from geographically and plan-wise? And what's giving you comfort that you're going to be able to reach your breakeven margin target?

SHAWN GUERTIN: I will turn it to Karen to talk about the dynamics of some of the marketplaces. But, so you are right, Matt, we are up about 200,000, a little bit less than that sequentially. Year over year we are actually down a little bit. We were at a little 1275, I think in the first quarter of last year, so we are at a similar level at the end of the first quarter, but it is up about 200,000.

KAREN LYNCH: Relative to the markets, we are seeing the growth in the markets where we have very good cost structure, particularly in the southeast. So Florida was a big growth for us, Georgia, North Carolina as well. We saw about 55% coming in for new business, and generally speaking, we have 75% of our membership in our top five states.

MATTHEW BORSCH: And on the margin outlook, with its influx of new memberships in light of the instability of financial results on the exchanges, how are you getting or seeking to get comfortable on that front?

SHAWN GUERTIN: Well, Matt, what we do know is the demographics of the new entrants look very similar to the demographics that we've had, so that doesn't look like a change. Again, I think -- I will remind everyone, our goal was to get this to approximately breakeven this year, so we're not trying to get this all the way up to a target margin level.

And in terms of what we saw in the first quarter, what I would say is, as we looked at 2015 continued to develop, whether that be prior-year reserve development, risk adjuster estimates and things like that, all of those estimates look good and either have held or improved a little bit. So that makes me feel good about the baseline that we're taking into 2016.

And as Karen mentioned, we're getting the growth in some concentrated markets where we know we have a good, solid cost structure. And it would be silly of me to declare victory for the year after the first quarter, but I think that the markers that we can see on that business make us feel pretty good about the goal that we've set for ourselves for this year.

MATTHEW BORSCH: Great, thank you.

OPERATOR: Andy Schenker, Morgan Stanley

ANDY SCHENKER, ANALYST, MORGAN STANLEY: Maybe just following up on MA and the growth you see, in particularly thinking actually more about margins, you got to your target margins a little early last year. How does the changes in the outlook for 2017 impact that, particularly the changes to EGWP Can you continue to maintain or even grow margins while still growing the top line? How have initial conversations been with your commercial or employer clients on the changes to EGWP Thank you.

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MARK BERTOLINI: The overall impact to us, Andy, is less than 1% across the whole rating environment. Obviously more on the employer side. We continue to see strength in the employer pipeline on Medicare advantage. We haven't seen anybody dissuaded from considering, given what the economic dynamics will be for 2017.

More importantly, to cover our contingency on that, we will be launching for January 1, 2017 our own individual Medicare exchange, which will allow employers to make a choice between continuing to offer coverage as a group or putting their employees into an individual product, and we have a lot of interest in that as well as we move into the year.

And I will note that we are on nine other individual Medicare exchanges, Medicare exchanges, but we will be launching our own product January 1, 2017 with the [B swift] platform, and we're excited about the opportunity there to cover our bases on the EGWP changes.

ANDY SCHENKER: Thank you.

OPERATOR: Sarah James, Wedbush.

SARAH JAMES, ANALYST, WEDBUSH SECURITIES: Thank you. Your guidance implies up to 100 basis points uptick in cost trends, and it sounded like hospital costs were in line to may be a little bit light in some areas. So are you seeing so far this year an uptick in line with your guidance, or is that just expectations for the remainder of the year? And then you've guided to pharmacy as a percentage of total, going up from about 15% to 20%, so are you seeing that uptick in pharmacy spend so far?

SHAWN GUERTIN: In terms of the first quarter, just to be clear, I think what we've priced in is about a 50 BP utilization increase in our forward pricing for trend. Again, in the first quarter of the year, we have largely booked consistent with that outlook. Again there is a lot of estimation always in this business and in the most recent quarter. So I think we've taken the approach of assuming that it is there in our booking.

SARAH JAMES: And on the pharmacy side? You guys had guided to an uptick, so if you could speak to if that is happening and what drug categories are driving it?

SHAWN GUERTIN: The pharmacy trend has been double digits and I wouldn't say there was anything particularly extraordinary in the first quarter on pharmacy trend that would make me move from that.

SARAH JAMES: And last clarification, was there any benefit from the new accounting guidance related to employee-based share payments? And can you speak to what that might be once it's implemented?

SHAWN GUERTIN: We did not implement that in the first quarter. We will obviously evaluate whether we will choose to adopt that early, and it would have a fairly minor impact, would be our estimate right now. But that remains -- we still need to do the work on that.

SARAH JAMES: Thank you.

OPERATOR: Kevin Fischbeck, Bank of America Merrill Lynch.

KEVIN FISCHBECK, ANALYST, BOFA MERRILL LYNCH: You guys highlighted a couple areas of potential concern or downside being trend and ACA impacts. But just wanted to see, you didn't highlight any areas of potential upside. I wasn't sure if there was anything you would highlight there as potential sources of upside or you whether you feel like the risk is somehow more skewed to the downside than the upside.

SHAWN GUERTIN: I wouldn't necessarily say that. Again, I think at this point in the year, the pricing is pretty well baked, your volume is pretty well baked. So what tends to move these things around more is how does medical cost play out? We have assumed that we are seeing the increase that we have priced for in the first quarter. And how that plays out will ultimately determine the sources -- the upside and downside around that.

KEVIN FISCHBECK: But as far as trend goes and as far as some of the ACA reconciliation, 3R-type accruals, do you think there's as much chance that there's upside on those numbers as there is downside or is there a reason to say that there is less visibility one way or the other?

SHAWN GUERTIN: I certainly -- we have tried to be careful around risk adjustment. It has been by far the most difficult thing to estimate on the ACA business. And so, I wouldn't ever get out in front of myself and say, we're going to have upside there. But given the uncertainty around that estimate, that is certainly a possibility. But we're not banking that that's going to play out wildly in our favor or anything.

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KEVIN FISCHBECK: Great. Thanks.

OPERATOR: Christine Arnold, Cowen and Company.

CHRISTINE ARNOLD, ANALYST, COWEN AND COMPANY: If you're willing to talk about Humana, could you give us a sense for what you're hoping to see this year to give you comfort and to make you feel good about where they are?

MARK BERTOLINI: Humana is still a competitor until we close, so we are engaged in integration conversations with them, to the degree we can be, without getting in front of the DOJ approvals and state approvals. They will report next week, and we'll let them get their information out. But we are in constant contact with them, and continue to believe that our model for the acquisition is a reasonable model.

CHRISTINE ARNOLD: With respect to small group, you were hoping to improve your margins there. Could you give us an update on whether small group margin improvement is on track? Thanks.

SHAWN GUERTIN: It's too early.

MARK BERTOLINI: Yes, it's early. I think the jury is still out on this. One of, again, to Kevin's question, risk-adjustment estimates around the ACA portion of this book are one of the swing factors that we still need to get improved clarity. I certainly wouldn't declare victory at this point.

CHRISTINE ARNOLD: Great. Thank you.

OPERATOR: Brian Wright, Sterne Agee.

BRIAN WRIGHT, ANALYST, STERNE, AGEE & LEACH: It looks like the reinsurance for receivable from the 3Rs went down sequentially by about $100 million. Could you help us understand what was driving that and did that have any impact on the quarter?

SHAWN GUERTIN: The biggest impact of moving that receivable is we did receive an interim payment of a little over $100 million in the first quarter related to prior years. So that's the real reason that went -- the reinsurance receivable went down. Obviously, given the timing, we don't accrue a lot of reassurance at the beginning of the year in that business.

BRIAN WRIGHT: Great. Thank you.

OPERATOR: Ana Gupte, Leerink Partners

ANA GUPTE, ANALYST, LEERINK PARTNERS: For the MLRs going into 2017, to your point around this is not just about the medical cost trend, but it's about the underwriting spread, how are you seeing the pricing environment playing out into 2017 as far as your competitors, some of, the Blues, who are losing money on exchanges? And to what degree are employers likely to tolerate continued increases in pricing, as you say the trend has been going up for the last couple years? If it gets to 7%, 8%, 9%, do you think that will hold now that exchanges are yet not a viable marketplace?

MARK BERTOLINI: I think for 2017, we're early, obviously, in that cycle. We're still finishing 2016. But the market is rational and probably more rational than it has ever been, given the impacts of the ACA on lose reserves and our competitors. I think folks are being much more careful about pricing to trend and making sure that -- and with the stark realization, quite frankly, Ana, that if you get behind on your pricing and you try and buy a share, you just can't catch up in any reasonable time. So I think people are being much more prudent about their pricing.

ANA GUPTE: And then just on the adjacency with the exchanges, you were, I think, getting to breakeven it sounds like on exchanges this year. So once the reinsurance goes away next year, do you think combined with the price increases from HHS and potentially some cost shifting to employers that your blended commercial loss ratio should still remain where it is right now, which is a very good result?

MARK BERTOLINI: I think, let's talk about the pricing on the exchanges. With the two Rs coming off this year, that's a 6-point impact on top of trend. That will have obviously, an impact on the exchange enrollment in some way, shape, or form, and the subsidies coming out of the federal government. We do hope to get to breakeven this year. We intend on -- we're looking forward to the next administration to improve the product as we move ahead.

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Let me just give you a different basis to think about our participation in the exchanges. We have 911,000 members on the public exchange as individual. We have 1.2 million members that are exchange or ACA compliant.

If we were to go out and buy those members, it would cost us somewhere around $1.2 billion to acquire them. If we were to build out 15 markets, it would cost us somewhere between $600 million to $750 million to enter those markets and build out the capabilities necessary to grow that membership.

So in the broad scheme of things, we are well, well below any of those numbers from the standpoint of losses we've incurred in the first two-and-a-half years of this program. So we see this as a good investment, hoping that we have an administration and a Congress that will allow us to change the product like we change Medicare every year, and we change Medicaid every year.

But we haven't been able to touch this product because of the politics. But if we can get to that point, we believe we are in a very good place to make this a sustainable program.

ANA GUPTE: Thank you for the color, Mark. Very helpful.

OPERATOR: Tom Carroll, Stifel.

TOM CARROLL, ANALYST, STIFEL NICOLAUS: Question on your government business, which has been very good in recent years, especially with Fran Soistman at the helm. But Medicaid results, I think, have been spotty here recently, with Pennsylvania yesterday being the most recent. And given that this is such a big revenue growth area, is this a stroke of bad luck for you guys or maybe something more structural within Aetna? I wonder if you could just give us more of a big picture discussion on what you guys are doing maybe to either improve things, or again, maybe this is just a stroke of bad luck? Thanks.

MARK BERTOLINI: I will remind you that we're up 230,000 members year over year in the product, in Medicaid, particularly. I will also say that we win more than we lose. That this is a much more competitive market than it has been in the past. Incumbents have less of a lock on these contracts than they have in the past, as state government struggle to control the cost around Medicaid, looking for innovation.

This is one that we didn't get what we wanted, but we have gotten expansions in other states and expect to grow through the remainder of this year in Medicaid. So I think we're doing just fine. I don't think we need to buy anything. I don't think -- we obviously will do the postmortem on this one and understand why we didn't get it. And we will learn from that, I'm sure and we will make changes. But we're doing just fine in Medicaid.

TOM CARROLL: As a quick follow-up, you guys provided a very helpful earnings waterfall on your last quarter in the slide deck that you did for your fourth-quarter call. I wonder if you could take the upside to guidance that you put out today and maybe spread it across those buckets. Did the negatives, like Kentucky get smaller, and the ACA improvements get bigger? Or if you could give us some flavor to that.

SHAWN GUERTIN: The two biggest pieces that would make up the increase are the prior-year development, which was obviously excluded from our previous guidance, and our improved performance, rather, in our fee-based businesses.

TOM CARROLL: Great. Thanks, Shawn.

OPERATOR: Scott Fidel, Credit Suisse.

SCOTT FIDEL, ANALYST, CREDIT SUISSE: Just actually wanted to follow-up on small group, and just interested if you can talk about how the pricing environment is looking in the small group side? Anthem yesterday had cited some increased price competition from one of the nonprofits in California. So just interested if you think that's more isolated and a one-off or if you are seeing any changes in the competitive pricing environment for small group?

KAREN LYNCH: Relative to the pricing environment, in California and Colorado and New York, as we had to convert to the ACA, particularly in the 51 to 100, there was a lot of volatility in that book. So we saw some competitive pricing in those couple of markets.

But generally speaking, it's a pretty rational market. We particularly, are very focused on our pricing discipline in the 2 to 50 ACA compliant business, as I have talked about in the past. As you know, you have to think about small group in three buckets, the 2 to 50, keep what you have. That is a stable, performing book for us. And then the 2 to 50 ACA compliant book where we have been very disciplined around our pricing. And then the 51 to 100

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book, where the states that didn't move to the Pace Act -- the states that did move to the Pact Act, we have been performing well and that book has been a good performance book for us.

SHAWN GUERTIN: Scott, I would emphasize, the one piece of that book, the small group ACA business, which we have talked a lot about, we had very consciously been careful about expanding into that space in advance to keep what you have coming off. There's an awful lot of moving parts in there, so we have been very deliberate with our pricing to be as careful as we can in advance of that.

SCOTT FIDEL: Got it. And just had a quick follow-up on the exchanges, and just relative to the markets where you're seeing the growth. North Carolina and Georgia have definitely been pretty tough markets for some of the competitors there. And BCBS in North Carolina has put out some warnings that they may consider exiting the exchange, given the huge losses that they have generated. Just interested, proactively, maybe how you're trying to position, given the growth in those two markets to protect against get some of the of potential loss dynamics that some of the competition have seen there?

KAREN LYNCH: We have been doing -- obviously, we continue to evaluate and assess our network and our contracting efforts around those markets. The second thing that we have been doing is very deliberate medical management actions. And then the third thing we are doing is making sure that we are focused on risk-adjustor. So we are in the middle of pricing for FY17 right now, so we're being very conscious of the dynamics in each of the marketplaces that we're playing in.

SCOTT FIDEL: Okay. Thank you.

OPERATOR: Dave Windley, Jefferies.

DAVID WINDLEY, ANALYST, JEFFERIES LLC: I think your commercial ASC membership was under some pressure because of some large accounts that moved to slicing. And wondered if those were one-off decisions or if you expect that trend to persist? And then on the lower end of say, large group, are you seeing -- are you continuing to see case sizes look at self-funding and convert from full risk to self-funding, and are you keeping those accounts when they do?

KAREN LYNCH: On your second part of your question, yes, we are seeing interest. We are seeing accounts move to ASC, and we have been keeping them. Relative to your first question, I would say there's continued interest in the ACA -- in the ASC book. We expect the market to continue to move that way in FY17 as well.

DAVID WINDLEY: Toward slicing of jumbo accounts?

KAREN LYNCH: Towards slicing of jumbo accounts, yes.

DAVID WINDLEY: Okay. Thank you.

OPERATOR: Chris Rigg, Susquehanna.

CHRIS RIGG, ANALYST, SUSQUEHANNA FINANCIAL GROUP: I just wanted to come back to some comments Mark had made a few minutes ago with regard to the need for some structural reforms, with regard to the ACA exchanges and the membership there. First question is, do you think these structural reforms could be done administratively without Congress? And then the follow-up is, if you don't get the structural reforms, if we look out a year or two, is the market sustainable? Thanks a lot.

MARK BERTOLINI: I think the kinds of structural changes that we need to make, I think Secretary Burwell and her team at CMS and HHS have done a really good job of using the regulatory framework that they can to try and improve the program in the short-term here. But there are bigger structural changes that need to be made around product flexibility, rating flexibility, pooling; we need different pools, not one pool. Cross-subsidizing at the premium level across a large swath of the population doesn't work; it needs to be multiple pools with specific products for each pool.

All of that requires legislative response, and that's not going to happen in the near term here. We will see the dynamics of the market get tougher as we go forward, if we don't get those kind of structural changes. How it affects us versus others? Quite frankly, we have been very careful to choose the markets we're in, as Karen noted earlier. We look for the right cost structure, we offer the kinds of products that we believe people need. But at some point, unless we make these kind of changes, the market will be challenged.

CHRIS RIGG: Great. Thanks a lot.

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JOE KROCHESKI: Thank you, Chris.

A transcript of the prepared portion of this call will be posted shortly on the investor information section of Aetna.com, where you can also find a copy of the updated guidance summary containing details of our guidance metrics, including those that were unchanged or not discussed on this call. If you have any questions about matters discussed this morning, please feel free to call me or one of my colleagues in the investor relations office. Think you for joining us this morning.

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