Q2 2016 Aetna IncEarnings Call - Final

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Presentation

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

(Operator Instructions)

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 second-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 guidance summary, which is 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 second-quarter operating earnings of $2.21 per share, an 8% increase over the second quarter of 2015.

Underlying our solid second-quarter performance, we grew operating revenue by 5% to nearly $16 billion. Our non-ACA commercial insured products performed consistent with our expectations.

Our commercial fee-based businesses remain strong and exceeded our previous projections. Operating results in our government business continue to be robust and performed better than projected. We have continued to drive operating efficiencies, as evidenced by our 17.1% adjusted operating expense ratio.

We achieved high single-digit pre-tax operating margins, consistent with our long-term target. And we grew operating earnings by 8%. The strong performance in our core business more than offset the significant pressure in our ACA individual products.

In short, we are pleased with our second-quarter and first-half results. They are representative of the rigor with which we operate our businesses and the value of a diversified portfolio in delivering solid bottom-line results.

As we look forward to the remainder of 2016, we continue to expect strong operating performance despite pressure from ACA products. Based on our results year to date, we remain confident in our operating EPS projection of $7.90 to $8.10 per share.

In a few moments, Shawn will provide a more detailed review of our second quarter results and current outlook, but first I would like to provide an update on our proposed acquisition of Humana, as well as share with you some of our second-quarter highlights.

Beginning with Humana, the combination of Aetna and Humana will benefit consumers, particularly those eligible for Medicare. We believe that the combination of these two complementary companies will meaningfully benefit the people we serve by: enabling us to create more attractive and affordable products and services, enhancing our ability to help expand value-based care delivery where providers are paid for the quality of the care they provide and not just the quantity of services performed, and accelerating our evolution to a more consumer-centric company that can provide simpler solutions and engaging tools to help people achieve their individual health goals.

As most of you are aware, we are in the process of defending the Justice Department lawsuit to block our proposed acquisition of Humana. The DOJ action ignores the simple fact that there is robust competition in Medicare, as evidenced by all Medicare eligibles are free to choose between traditional fee-for-service and Medicare Advantage, and approximately 70% of the Medicare-eligible population chooses traditional Medicare.

A total of 178 Medicare Advantage organizations offer plans with 28 new organizations entering MA in the last three years alone. 91% of Medicare beneficiaries have access to at least five Medicare Advantage options. And healthcare is delivered locally, and regulators in 18 of 20 states have already approved the transaction.

Finally, as the Justice Department states in its complaint, Congress created Medicare Advantage in 1997 to offer seniors a market-based alternative to traditional Medicare. This is consistent with a market definition that includes both traditional Medicare and Medicare advantage and the presentation on the government's Medicare.gov website of options available to newly eligible beneficiaries. Consequently, we don't believe divestitures should be required at all.

However, after reviewing bids from significant industry players, this morning we announced that we and Humana have executed agreements with Molina to sell certain of our respective Medicare Advantage assets. We believe that, taken together, these divestitures would address the DOJ's perceived competitive concerns regarding Medicare Advantage.

Shifting to our second-quarter highlights, our commercial fee-based businesses performed well on the second quarter. Fee yields remained healthy and pharmacy results were strong, driving better than projected operating earnings.

As we look forward to the 2017 selling season for large ASC accounts, the RFP pipeline looks more modest than last year, with fewer cases out to bid. While we expect our 2017 new sales to reflect this pipeline, we are encouraged by our retention efforts this year and project better retention in our commercial ASC membership in 2017 compared to this year.

In our commercial insured business, our large group products are performing generally consistent with our pricing assumptions. However, as Shawn will discuss in more detail, our ACA small group and individual products continue to be challenged by deterioration of the risk pool and an ineffective risk adjustment mechanism. As it relates to these challenges, let me take a few moments to provide an update on our public exchange strategy.

Our strategy has always been to participate on the exchanges in a manner that will allow us to gain enough membership to learn how best to provide affordable health care coverage for previously uninsured Americans. At the same time, we are committed to being good stewards of our balance sheet and managing the financial risk and level of investment associated with this opportunity.

In light of the disappointing year-to-date performance and updated 2016 projections for our individual on- and off-exchange products, combined with significant structural challenges facing the public exchanges, we believe it is only prudent to reassess our level of participation on the public exchanges. Our initial action will be to withdraw our 2017 public exchange expansion plans. Additionally, given the deadline to attest to our final rate filings for 2017, we are also undertaking a complete evaluation of our current exchange footprint as the poor performance of these products warrants such an analysis.

Moving on to our government business, our government business is having another strong year. We grew to serve nearly 0.5 million additional medical members over the past 12 months. We generated over 15% year-over-year growth in government premiums for the quarter, and we generated operating margins consistent with our targeted range.

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More specifically, our Medicare business is currently on pace to have another solid year of operating performance driven by strong membership growth. The investments we have made in our value-based care models for Medicare Advantage beneficiaries helped to drive the strong financial performance.

These type of value-based care models have demonstrated performance improvements for the Medicare beneficiaries we serve. For example, for calendar year 2015, beneficiaries in our value-based models achieved improvements in clinical quality, including breast and colorectal cancer screening rates and diabetes control.

In all, members in these arrangements outperformed populations in non-value-based models on a majority of clinical quality measures. Encouraged by these results, we are pursuing a robust pipeline of additional value-based provider contracts in conjunction with our broader population health strategy.

Additionally we made good progress during the quarter toward our goal of helping the people we serve achieve more healthy days through our broader provider collaboration strategy. Specifically, in May we announced the creation of a jointly owned health plan company in partnership with Texas Health Resources, one of the leading healthcare provider systems in Texas. The combination of Texas Health's high-quality providers and investment in population health management, with Aetna's health plan expertise, care management capabilities and analytical insights, will provide the people of northern Texas with more affordable, high-quality and better coordinated care.

This joint venture is just one of the provider collaborations we entered into in the quarter across the spectrum of value-based care models. With over 40% of our medical costs now flowing through these value-based care models we are well positioned to achieve our goal of 75% by 2020.

In summary, we are pleased with our first-half 2016 performance. I want to thank our employees for their efforts in delivering another strong quarter for Aetna and our shareholders, as well as all of those employees of both Aetna and Humana who have been working tirelessly to close our transaction and deliver a successful integration. With our second-quarter results I am confident we have the right vision to lead in the changing healthcare marketplace, we can continue to execute on our differentiated strategy, and we can achieve our 2016 operating EPS projection of $7.90 to $8.10.

I will now turn the call over to Shawn who will provide additional insight into our second-quarter results and our current 2016 outlook. Shawn?

SHAWN GUERTIN, CFO, AETNA INC.: Thank you, Mark, and good morning, everyone. Earlier today we reported second-quarter 2016 operating earnings of $783 million and operating earnings per share of $2.21. Aetna's operating results continue to be supported by strong top-line growth, cash flow, and operating margins. I will begin with some comments on overall performance.

We ended the quarter with 23 million medical members, essentially flat with the first quarter of the year. We grew operating revenue by 5% over the prior year to a record quarterly level of nearly $16 billion, driven by higher healthcare premium yields and membership growth in our government business, partially offset by membership declines in our commercial insured projects.

From an operating margin perspective, our businesses are performing quite well. Our pretax operating margin was 8.9%, a very strong result and consistent with the high end of our target operating margin range. Our second-quarter total health medical benefit ratio was 82.4%, a 130 basis point year-over-year increase, driven primarily by performance in our individual commercial products and lower favorable development of prior-period healthcare cost estimates in our government business.

Our adjusted operating expense ratio was 17.1%, a 120 basis point improvement over the second quarter of 2015. This year-over-year improvement speaks to our strong commitment to drive productivity improvements and our disciplined focus on managing our operating costs as we continue to grow our top line.

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 first-quarter 2016 dates of service. Our reserve growth exceeded our premium growth in the quarter and on a year-over-year basis.

Additionally, days claims payable remain at a healthy level, standing at 56 days at the end of the quarter. The sequential decline of approximately one day is consistent with the expected improvement in claim processing speeds as processing times improved from the elevated levels of the first quarter. Note that our days claims payable has increased by over four days as compared to the prior-year quarter.

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Turning to cash flow and capital, year-to-date offering cash flows have been strong. Healthcare and group insurance operating cash flows were approximately 1.5 times operating earnings. We did not repurchase any shares during the quarter due to the proposed Humana acquisition. However, we did return $88 million to shareholders through our quarterly shareholder dividends.

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

Beginning with our government business where we continue to experience strong momentum, our government medical benefit ratio was 81.4%, an excellent result and favorable to our previous projections. We grew medical membership by nearly 100,000 members in the quarter including growth of 12,000 in Medicare advantage, 25,000 in Medicare supplement, and 61,000 in Medicaid.

As a result of the strong medical membership growth, we grew our second-quarter 2016 government premiums by over 15% compared to the prior-year period, achieving a record $6.6 billion. Government premiums now represent nearly 50% of our total healthcare premiums, and this business continues to perform at a very high level.

Turning to our commercial business, our commercial fee-based businesses are performing well. We grew our fee revenue in the quarter as compared to the same period last year. And margins remained healthy, driving year-over-year operating earnings growth that exceeded our previous projections.

In our commercial insured products, membership declined by roughly 125,000 members in the quarter, driven by attrition in our individual and small group membership, largely consistent with our expectations. Our commercial medical benefit ratio was 83.4% for the quarter. This result was higher than expected as a result of the performance of our ACA individual products. The performance of our non-ACA commercial products was consistent with our previous expectations.

Looking more deeply at our ACA individual products, we can now see that our 2016 population, of which roughly half are new members, have a distinctly higher level of morbidity than our 2015 population. This resulted in higher medical costs in the quarter than previously projected.

Our second-quarter performance was also negatively impacted by updated estimates related to the 3Rs, including amounts related to prior-year dates of service. As a result of these two items, we no longer project we will achieve breakeven in our individual products in 2016 and have established a premium deficiency reserve in the second quarter of $65 million related to second-half 2016 projected performance.

The combination of all of these factors contributed to an approximate and $200 million pretax operating loss in the second quarter in our individual products. As Mark mentioned earlier, in response to our updated view of these products, we are reassessing our public exchange approach for 2017 as part of our broader action plan to improve the financial performance of our individual ACA products.

Moving on to our small group insured products, pretax operating earnings in the quarter were largely in line with our previous projections. However, this result reflects a favorable risk adjustment update from CMS related to 2015 that largely offset higher than projected medical costs. The higher than projected medical costs were almost entirely driven by our ACA small group products and are a function of the continued degradation of the risk pool in certain states.

As you know, our previous projections incorporated improvements in pretax operating margins in our small group products in 2016, particularly in our ACA products. While we continue to believe we will improve our small group pretax operating margins in 2016, we project the underlying pressure on medical costs in our ACA small group products will persist for the full year, limiting our ability to achieve all of the 2016 targeted improvement.

For 2016, our non-ACA commercial pricing incorporated a moderate increase to medical cost trends. Based on year-to-date results, we believe that our non-ACA commercial insured products are performing consistent with this expectation. As a result, we continue to project that our 2016 non-ACA commercial medical cost trend will be in the range of 6% to 7%. While disappointed by the performance of our ACA products in the quarter, the strong performance of our core business more than offset these ACA results.

Moving on to the balance sheet, our financial position, capital structure and liquidity all continue to be very strong. At June 30, we had a debt to total capitalization ratio of approximately 54%, which reflects the debt financing we completed in June to fund a portion of our pending Humana acquisition.

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Looking at cash and investments at the parent, we started the quarter with approximately $970 million. Net subsidiary dividends to the parent were $1.2 billion. We paid a shareholder dividend of approximately $88 million. And, after other uses, and excluding the funds raised from our debt financing in June, we ended the quarter with approximately $2.1 billion of cash at the parent. Including the funds from the June debt financing, we ended the quarter with approximately $15 billion at the parent.

Our basic share count was approximately 351 million at June 30. Based on our year-to-date performance we are affirming our 2016 operating earnings-per-share guidance of $7.90 to $8.10 per share. This reflects the strong performance in our core business, particularly our government business, and our continued focus on operating costs, offset by our updated underwriting margin projections for our ACA products.

Our current 2016 guidance is influenced by the following additional drivers. Based on our second-quarter membership results, we continue to 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 continued attrition within our individual products.

We now project that operating revenue will be approximately $63 billion in 2016. We now project that our full-year total health medical benefit ratio will be in the range of 82% to 82.5%. The increase from our previous projection is driven by our updated view of our ACA products.

Based on our improved outlook on adjusted operating revenue and continued cost control initiatives, we now project that our operating expense ratio will be approximately 18%. We continue to project pretax operating margin to be at least 8%, consistent with our high single-digit target. We continue to project operating earnings of approximately $2.8 billion. Finally, we continue to project excess cash flow to the parent of up to $2.4 billion.

In closing, we are encouraged that the strength of results in our core businesses has been powerful enough to absorb the disappointing performance in our ACA products. Specifically, our Medicare business in both group and individual continues to deliver strong top-line and bottom-line results and is performing ahead of our previous projections.

Our fee-based businesses continue to produce strong margin and operating profit growth. Our core non ACA commercial insured business remains healthy and is performing consistent with expectations. And, finally, our strong focus on expenses is delivering operating cost efficiencies that are tracking ahead of our initial projections for the year.

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

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 as many individuals as possible have an opportunity to ask their questions. Operator, the first question please.

Questions and Answers

OPERATOR: Justin Lake, Wolfe Research.

JUSTIN LAKE, ANALYST, WOLFE RESEARCH: First, in terms of the divestitures to Molina, given their relative lack of experience in Medicare Advantage, I was hoping you could share what type of infrastructure assistance, like network, brand, and stars you are providing within the deal structure to convince regulators Molina can be a strong competitor post the purchase.

SHAWN GUERTIN: Sure. As part of the agreement, we will obviously be providing transition services, which would include network continuity. And this will allow for hopefully a seamless experience for the member to continue in the network they are and give time, obviously, for Molina to ramp up what they will need eventually to take over the business. So, that has been fully contemplated in the business.

Again, they do have some experience in Medicare Advantage through the special needs plans and through some of the duals plans. But we really thought about how to do this as smoothly as possible in the form of some transition services agreements.

JUSTIN LAKE: Okay. And then, Shawn, clearly the business is operating well and offsetting the disappointing ACA results. I was just hoping whether you could tell us whether there are any one-time positives that are helping to mitigate here. Or can we take 2016 results and add back the individual losses to get the core earnings power for Aetna going into 2017?

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SHAWN GUERTIN: A couple things. As I mentioned, on the small group ACA business, we did get a prior-year pickup on risk adjustment. So, that was certainly something that came from 2015. I would tell you, though, that on individual, we had a number of things that then went the other way, and the net around all three Rs is somewhat of a wash.

I would be a little careful doing that at this juncture in terms of projecting for next year. There is always issues with expense structure behind these products and things like that that you need to think through. But certainly it would be our intent to improve this result for 2017.

JUSTIN LAKE: Great. Thanks.

OPERATOR: Josh Raskin, Barclays Capital.

JOSH RASKIN, ANALYST, BARCLAYS CAPITAL: The divestiture package that you proposed or that you've announced with Molina, was that previously proposed to the DOJ or is this something new to them? And how does that factor into what you think the potential trial date could be?

MARK BERTOLINI: Josh, the form of it has been in front of the DOJ before with a number of other parties that were seeking to acquire the full book of business. In response to a number of issues that were outlined by the Department of Justice in their complaint, we decided that Molina was the best opportunity, but we had to update the divestiture to meet the specific requirements that were outlined in the Department of Justice's complaint.

JOSH RASKIN: Okay. So, Mark, it sounds like the DOJ, in your mind, has had time to vet and do the diligence and interview, et cetera, the potential buyer in this case?

MARK BERTOLINI: I would say they have done their homework

JOSH RASKIN: And then, second -- apparently they didn't have your answer sheet. The second question, just on the total ACA book, individual and small group, if you think about the total losses that are being absorbed in 2016, one, what is the incremental amount relative to your previous expectations? I think it was breakeven so I think it is all incremental. And, two, if you were to exit exchanges, would that simply clear all of this up or are there some other costs that would stay with the Company?

MARK BERTOLINI: It is all incremental. We expect the year to have a loss on ACA business of in excess of $300 million. We are evaluating our footprint at is exists today, to understand what solutions we can put forward to either fix the business or exit the business. So, we're going through that analysis now. As you know, there's a short window to divestitures.

But the solutions here are really two. First, let me make the comment that the people that are seeking care through these exchange products need this care. These are not people running off to get services that they don't need. These are people that need the care that they are getting.

What we're seeing in the exchanges is double-digit trend year over year, overall. You can double that when you talk about pharmacy, and you can triple that initial number when you talk about specialty pharmacy.

So, we have two very important things going on in the exchanges here. First, we now believe we have third parties paying premiums for special interest groups, both in small group and individual, that are supporting people getting access to these services. And because of that, while we have the same demographic mix in this population, we have a much higher intensity and morbidity in that population, largely around specialty pharmacy.

So, given that the current risk adjustment mechanism does not include pharmacy, nobody is getting adequately reimbursed. And given that the risk adjustment mechanism is a zero sum game, there's no way to fix this unless we include pharmacy, we deal with the eligibility requirements of third-party payers paying premium, and we find a way to cover these individuals. Again, these people need this care and it's appropriate that they get it. But it's really about how the system works.

SHAWN GUERTIN: Josh, let me just clarify for you and everyone else to just where these numbers are, because there is a lot things moving around. As I mentioned in my remarks, on individual ACA we booked a pretax loss of about $200 million for the second quarter. The number Mark mentioned, north of $300 million pretax, that is our outlook for the year for the individual ACA business for the full year. That was obviously a business that we had been trying to get closer to breakeven, so you can really think about that total swing as a swing from where we've been.

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Small group continues to be profitable overall and we had wanted to see some improvement there, particularly in the ACA business. So, we are better year over year from an earnings perspective in small group, but just not as much as we had originally incorporated into our thinking for this year.

JOSH RASKIN: Okay. That is perfect. Thank you guys.

OPERATOR: AJ Rice, UBS.

AJ RICE, ANALYST, UBS: Obviously there are some moving parts here, but your updated MLR guidance of 82% to 82.5%, you are 81.5%, if I've got the calculation right, in the first half. So, you are assuming some deterioration in the back half, but the first half includes of the PDR and the exchange drag. I know seasonality is a factor. Are there anything else that we should think about as we move from first half to back half and think about putting this all together?

SHAWN GUERTIN: There's a couple things, and you're on to the most important issue, which is the strain in both the ACA individual and small group products tends to worsen as the seasonality of the year intensifies. So, there is some degradation in our forecast. And I'll go back, as well, in the quarter in small group we did benefit from getting the 2015 risk adjuster update. Without that we would have seen more pressure in the second quarter.

So, what you're seeing is that pressure continuing on in the appropriate seasonal progression for the rest of the year. So you have that clearly creating pressure. And, as I mentioned, the government MBR, though, is helping and is better. The fee-based businesses are helping and they are better. Our non-ACA commercial business is consistent with expectations through the rest of the year.

AJ RICE: Okay. And then Mark's comments about what the problems with the exchanges are don't suggest that there's much geographic diversity, but I did want to just check that and see, as you are painting the picture, is it bad across the board? Can you see areas where it is actually working okay? And if it is working okay in some areas, what is driving that?

KAREN LYNCH, PRESIDENT, AETNA INC.: We do have geographic variation in both our individual and small group ACA business. What I think is working, where it is working, is where we have very tight, narrow networks where we are effectively managing our medical costs. What Mark described relative to the third party, we see that in various geographies, as well. That's putting pressure on us in some of the markets.

AJ RICE: Okay. All right. Thanks a lot.

OPERATOR: Matthew Borsch, Goldman Sachs.

MATTHEW BORSCH, ANALYST, GOLDMAN SACHS: Maybe I could just pick up on a question that I believe Justin asked, which is, on your planned divestitures to Molina, can you just elaborate further how you would help them to sustain the Medicare Advantage business in those markets or how you think they would do that? The backdrop here is their management having said at various points in the past, or at least somewhat recently, that they did not plan to be in regular retail Medicare Advantage. I didn't know if there is something special about this enrollment that you are planning to divest. Could you just give us a little more detail on that?

MARK BERTOLINI: I think we will let Molina speak for their abilities to deal with this. But I can tell you, we have a transition service agreement in place for an appropriate amount of time, not too long, not too short -- they will outline more of that -- that covers the network, covers the administrative services, and allows the stars to transfer over.

SHAWN GUERTIN: And we have every intention, obviously, to treat this business just the same way we would treat our ongoing business throughout this process. And, again, this is all designed to provide a scenario of minimal disruption to the consumer.

MATTHEW BORSCH: Got it. And just as a follow-up, you talked about outperformance yourselves in Medicare Advantage. Did you see any Medicaid rate pressure or margin pressure as a result of the resets this year?

SHAWN GUERTIN: Clearly Kentucky has been a market that, as the rates have been now reset for a period of time. So if you thought about that year over year, you would certainly have that as one of the markets. That's probably the most notable one. There are always oscillations from quarter to quarter but that would be the real meaningful one.

MATTHEW BORSCH: Okay. Thank you.

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OPERATOR: Peter Costa, Wells Fargo.

PETER COSTA, ANALYST, WELLS FARGO SECURITIES, LLC: Thanks. Can you talk about, you mentioned the retention in the ASO business for 2017 being a little bit better. Do you actually expect the ASO business to grow next year, or flat, or decline? Can you give us an overall picture of what that will be?

And then in terms of looking at the ACA individual business for 2017, you talked about reevaluating it. Are you saying that you're actually going to actually re-evaluate before September and you may exit some of the 15 states you are in now?

MARK BERTOLINI: On the second part, Peter -- and I'll let Karen answer the first -- we are evaluating all of our exchange footprint, and we are doing it within a timeline that allows us to react well before September 23.

KAREN LYNCH: And on the national account business, what I would say is, the pipeline as it has matured was lower than last year, so we aren't going to expect sales as robustly as we saw in 2016. We are encouraged by our retention efforts to date. And what I would say is we are still actively engaged in bids, so it's something that we are assessing. I wouldn't expect to grow in 2017 on the national account space.

PETER COSTA: Thank you.

OPERATOR: Kevin Fischbeck, Bank of America Merrill Lynch.

KEVIN FISCHBECK, ANALYST, BOFA MERRILL LYNCH: Thanks. I just want to understand a little bit the commentary about exchanges for next year. What does it mean to you to be appropriate for evaluating participation? Is it of you getting to breakeven next year? Do you have to be profitable next year? And does this impact at all the negotiation discussions you have had around the Humana merger agreement about staying in or getting out of the exchanges?

MARK BERTOLINI: Kevin, this is really a balance sheet discussion and what happens to our capital and how big the loss could get. Unless some of these issues are addressed around eligibility and the risk adjustment, this could get a lot worse.

So, we have to evaluate each market by its level of volatility, the other competitors, our amount of share in that market, and whether or not it is appropriate for us to take that risk absent any other changes in the program. So, that is the sole evaluation around our exchange footprint.

Obviously as it relates to the other discussion with the Department of Justice, all of this material goes into a review of markets as they have reviewed, and that is a separate conversation from our evaluation of how we think about the exchanges going forward.

KEVIN FISCHBECK: Okay. And then just to clarify the comment that you made about this divestiture package and how you came to an assumption that this would be the best structure to address the issues that the DOJ brought up in their complaint, how different is this package versus what you had presented to the DOJ before they decided to pursue a lawsuit?

MARK BERTOLINI: That I would not want to comment on at this point in time. I think this is something that is now in front of a judge and we want to be careful about how we talk about this. As scintillating as all the legal theory may be -- and, believe me, we have had our share of it -- it is something that we need to put in front of the judge and let him decide.

KEVIN FISCHBECK: Okay, great. Thanks.

OPERATOR: Gary Taylor, JPMorgan.

GARY TAYLOR, ANALYST, JPMORGAN: Good morning. I was wondering if you could comment on the duration of the changes in service agreement with Molina, how long that would be?

MARK BERTOLINI: Maybe, Shawn, you could comment on it.

SHAWN GUERTIN: It would depend on some of the timing of the ultimate close. It could be through 2017 and if the close was later it could extend into 2018. Again, the buyer, if they are ready sooner than that, always has the option to assume full responsibility and exit that transition service agreement for certain markets when they are ready. But ultimately it will be a byproduct of the timing of close.

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GARY TAYLOR: Okay. When we look at the price per member here, $400 per member, which is quite low versus historic deals, what does it say about the profitability of this group of lives? And what does it say about Molina's realistic expectations of retaining this membership through an open enrollment period?

SHAWN GUERTIN: I won't get into the specifics right now but I will tell you this is a profitable book of business. The valuation that you're citing is a per member valuation ex any capital. So, keep that in mind. I'm not sure what you are comparing it to. Typically people talk about the bigger numbers but they include the regulatory capital. That number is ex any capital.

GARY TAYLOR: And then last question, ACA individual book, you are now saying lose $300 million pretax versus your previous expectation to get to break even this year. Yet the PDR is only $65 million. I just wanted to understand that. And I wanted to confirm, it implies ACA individual be roughly a negative 10% pretax margin for the year.

SHAWN GUERTIN: That is a little high, but we are up into certainly the high single digits now as a margin for the full year. And, again, keep in mind when you compare this to some of the other larger numbers you've heard, this is only for six months. While we have been in a loss position in 2014 and 2015, we have not been in as deep a loss position as others have been.

You now probably are all experts in how the PDRs are calculated. You don't count all of the SG&A expenses so it tends to be a fraction of what your period losses would actually be on a fully reported basis.

GARY TAYLOR: Okay. Thank you.

OPERATOR: Christine Arnold, Cowen.

CHRISTINE ARNOLD, ANALYST, COWEN AND COMPANY: I am hoping we could talk a little bit, recognizing that you fully plan to close the deal, are you willing to talk about a plan B if the transaction doesn't happen -- how much capital you have, what kinds of deployment of capital you are thinking about, what kind of growth rates you are thinking about in terms of Aetna standalone and other opportunities?

MARK BERTOLINI: First of all, Christine, we think we're going to get the deal done, we believe we're going to get the deal done. But it would be irresponsible for us not to have a plan B in place and to understand all of the levers we could pull. We have reviewed the financial aspects of that with our Board but have not finished all the various market impacts and growth rates, et cetera, on the plan.

I think our long-term strategy is still our long-term strategy. The Humana combination allows us to get at certain assets in certain markets sooner than we otherwise would if we had to build it or buy it in other ways. So, our view is that we get the deal done, we have a plan B on the sideline, our long-term strategy doesn't change, and we have already reconsidered all of the capital redeployment. It is too early to go there. We are focused on getting our deal done.

CHRISTINE ARNOLD: And if the deal doesn't go through, how much of the transaction costs actually go away? Do 100% of the transaction costs that you've got below the line go away? Or is some of that -- your time, Shawn's time, the accounting department's time -- how do I think about ongoing SG&A standalone?

SHAWN GUERTIN: The easiest way to think about it is there would be a bit of a wind-down, but they would go away. We are not putting pieces, for example, of my time below the line. Those would be people who are fully dedicated to either work on the transaction and work on integration. Those people were taken from other jobs and they would go back likely to those jobs. So, eventually those would go away after a wind-down period.

CHRISTINE ARNOLD: Okay. Thank you.

OPERATOR: Andy Schenker, Morgan Stanley.

ANDY SCHENKER, ANALYST, MORGAN STANLEY: Medicare Advantage continues to be strong. So, maybe if you can discuss your positioning for next year given your bids. And you continue to say you're within target margins. Are you looking for margin expansion next year or membership growth excluding divestitures? And then related to that, how have conversations been developing on the group MA side? Thank you.

MARK BERTOLINI: Let me speak to next year. I think we see a less than 100 basis point deterioration in the funding for Medicare Advantage, which we believe we can solve given the levers that we have to pull in multiple markets.

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As it relates to margin, it depends on the market. Medicare Advantage is local. It is a local market discussion. We have some markets that are at top margins and other markets that are performing under and we'll continue to work on all those markets to improve it.

We continue to see good opportunities for growth, particularly with our star ratings, and expect that we will be able to continue to grow the top line on the book of business. So, I think we are in a good place.

ANDY SCHENKER: And then for group, are you seeing, since the changes came out, any material conversations with some of your group clients about private exchanges or anything else?

KAREN LYNCH: Relative to group, we have seen a very strong pipeline. We feel good about our prospects on the group Medicare side. We grew membership in 2015, we grew membership in 2016, we expect to have some modest growth in 2017, as well.

ANDY SCHENKER: Okay. And then just lastly here, PPRD on the roll forward table is still quite strong, though in the release you suggested government was lower, as you had called out previously. Does that mean commercial was better? Maybe if you could talk about some of the trends you saw in prior period reserve development. Thank you.

SHAWN GUERTIN: Yes, it was across the board. And, again, that comment, I believe, in the press release is a year-over-year, quarter-to-quarter view as opposed to did you get prior year or not. When you look at the roll forward, and when you look at the things like minimum MBR accruals which offset some of that prior-year development, it was probably worth around $0.10 in the quarter going back to last year.

ANDY SCHENKER: Thank you.

OPERATOR: Chris Rigg, Susquehanna Financial Group.

CHRIS RIGG, ANALYST, SUSQUEHANNA FINANCIAL GROUP: I just wanted to clarify some of your comments earlier, Mark, on Molina. You said that the DOJ had done their homework on Molina. But at the same time, obviously, they've thus far rejected the remedies that you've proposed. So, do you know whether the DOJ views Molina as a suitable buyer, or that's still up in the air?

MARK BERTOLINI: That is not something I could comment on. This will be in front of the judge to review. So, I think that's a further conversation that will continue to be had.

CHRIS RIGG: Okay. And then, Shawn, I believe you said in your prepared remarks roughly half your ACA compliant members are new to Aetna. Did I hear that correctly? And then you talked about the morbidity being worse now than what you expected earlier in the year. Is the morbidity worse in the new members only or is it across the board? Thanks.

SHAWN GUERTIN: Yes, that statement, half that was specific to our individual membership. And the morbidity degradation is across the board, both existing but also particularly in the new members that we have.

CHRIS RIGG: Great. Thank you.

OPERATOR: Dave Windley, Jefferies.

DAVE WINDLEY, ANALYST, JEFFERIES LLC: Thanks for taking my questions. Gentlemen, do you view the Molina divestiture package as the complete response to the DOJ's concerns or should we expect that there might be another transaction announced?

SHAWN GUERTIN: We think it responds in total to the DOJ's perceived issues around individual Medicare Advantage.

DAVE WINDLEY: And did you consider divestiture of businesses that would obviate the need for these interim transition services agreements? And, if so, why were those not feasible?

SHAWN GUERTIN: I'm not sure I understand your question, Dave. Could you explain it a little bit more?

DAVE WINDLEY: Divesting a plan or a business with brand, with network, with contracts, et cetera, in place, where the acquirer is buying all of that in a package. That essentially the member stays with the product and with the plan and with the network that they are on under you, they would transition all of that to the buyer. Is that not feasible?

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SHAWN GUERTIN: Effectively, a lot of these things are not in clean legal entities that allow that sort of neat separation that you are describing. But effectively the transition service agreement provides exactly what you are describing in terms of brand continuity, service continuity, network continuity. So, effectively that is exactly what the consumer will experience.

DAVE WINDLEY: Okay. Just last question, switching gears, the efficiencies that you have talked about on the G&A front are pretty significant. Could you talk about some of the sources of those savings? I think you're seeing some absolute dollar declines in G&A there. Thank you.

SHAWN GUERTIN: This is really the ongoing maturation of a fairly significant initiative that we've had in the Company, where we apply some of the tools around value stream design and lean and Six Sigma to our end-to-end processes in the Company. So, to your point, if you look at our revenue growth and our absolute levels of G&A you can really continue to see a payoff in this particular area. We've been working through a lot of significant processes all across the Company now for a better part of probably a year and a half, and I think we are beginning to see the early pay-off as a result of that.

MARK BERTOLINI: These investments in the quality of our processes and making them simpler is going to be better for our retail market. So, it's an effort we have had underway for the last four years. Shawn pulled together a team that we pulled out of UTC, and they have really started to get some traction. So, we are excited about the prospects for that work going forward.

SHAWN GUERTIN: And I would emphasize Mark's point that this just isn't simple expense cutting. This is really meant to improve the quality of the end product to the customer, of which then efficiency savings fall out of better, more efficient processes.

DAVE WINDLEY: Okay. All right, thanks.

OPERATOR: Scott Fidel, Credit Suisse.

SCOTT FIDEL, ANALYST, CREDIT SUISSE: Thanks. Just on the tax rate it looks like you took that guidance down by around 100 to 150 bps. Just checking on what the drivers of that was. Was that the HIX losses affecting that or something else?

And then just a quick follow-up would be, the exchange lives in terms of where you ended 2Q -- I think you were at 911,000 in the first quarter -- where that was in 2Q, and what you are expecting attrition for the back half of the year to be. Thanks.

SHAWN GUERTIN: Let me have Karen do the exchange lives and I'll come back on the tax rate.

KAREN LYNCH: We finished the quarter at 838,000 exchange lives at the end of June.

SHAWN GUERTIN: The tax rate is a couple things. As the earnings move around there in proportion to the health insurer fee, there's some natural movement in that tax rate. So, as we do better on the earnings front it tends to bring that tax rate down a bit.

But we also did implement the new accounting policy that some other people implemented in the first quarter around some of the equity comp treatment. That had a very minor effect in the quarter. But that's also in there.

SCOTT FIDEL: Okay. Got it. Thanks.

OPERATOR: Sarah James, Wedbush Securities.

SARAH JAMES, ANALYST, WEDBUSH SECURITIES: Thank you. How should we think about the geographic dispersion of the book being divested? Is a concentrated for local density or dispersed? And then what portion of this book is star bonus-eligible? For 2017 we were estimating Aetna's about 87%, Humana 77%, so is it in that range or is it more of an outlier book of business?

SHAWN GUERTIN: I can certainly follow up. I don't know the exact star composition of this book of business in terms of in comparison to our 87% statistic. But needless to say, both Aetna and Humana are number 1 and number 2 in star ratings, so there is a good chunk of this business that has very high star ratings. And the purchase agreement assumes that those star ratings will continue to follow these members going forward.

SARAH JAMES: And the geographic dispersion on this? Are these locally concentrated groups that you are divesting or are they pretty spread out?

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SHAWN GUERTIN: They are specific counties. We certainly thought about some of the issues around like the PPO products, for example, and have grouped those together where we think appropriate. It's obviously in 21 states, I believe, as you saw in the press release, but we have thought about that where appropriate.

MARK BERTOLINI: The counties are outlined in the DOJ complaint. Where we had PPO product that touched those markets, we added actually more markets so that they could continue giving the same great experience to the members that we have given them.

SHAWN GUERTIN: The counties are all out there to be found.

OPERATOR: Lance Wilkes, Sanford C. Bernstein.

LANCE WILKES, ANALYST, SANFORD C. BERNSTEIN & CO.: Thanks for taking the questions and appreciate the color on the divestitures. Just had a follow-up question. It sounded, Mark, like you had talked about strength in the pharmacy results. I was interested in what drove that and how large of an impact it was.

SHAWN GUERTIN: Our pharmacy business, particularly around our self-insured customers, has continued to do very well. It has continued to grow year over year. That has actually been an ongoing story.

LANCE WILKES: Okay. And one follow-up. Over on the selling season, it sounds like there has been a little slow down -- not for you guys but just industry-wide -- as far as RFP activity. Have you seen any progress on the private exchange side there? And, if so, what is your folks' outlook for that?

KAREN LYNCH: You're right that there has been a slowdown in the RFPs. There's been modest interest in the exchanges. We think people had to wait and see when the Cadillac tax changed. We are seeing some activity, but not as much as we had anticipated.

LANCE WILKES: Okay. Thanks.

OPERATOR: Ana Gupte, Leerink Partners.

ANA GUPTE, ANALYST, LEERINK PARTNERS: Thanks for squeezing me in. I appreciate it. On the commercial group business, you have had so many things going on internally and there's so much going on externally. I am just curious how you're thinking about margin versus membership there. The fact that you cited your commercial book this year, you lost membership. You are not seeing individual, you won't have any expansion plans next year. The DOJ, you don't really know what will happen and it will be during your selling season. And simultaneously I would expect the employer market may stabilize just because Obamacare is leaving all these exits in its wake. And the small group definition is better. How should we think about margin expansion again on MLR next year, or stable MLR, or more about a focus on membership?

SHAWN GUERTIN: Our MO around the commercial risk business in particular has been to be cautious -- cautious in terms of thinking about a trend increase and cautious of some of the new things coming into the market like ACA. I am certainly glad we have done that.

I do think it is important, though, I would not characterize it that we have had a number of issues. We have had one issue, really, in our group business and that is the small group business, and particularly the small group ACA business. Large group has been a very steady performer last year and this year. Frankly, even within small group, our non-ACA business is performing quite well. So, this is really localized.

As I mentioned in my remarks, we did assume that in our pricing we would have a moderate trend increase this year, and that looks to have been a good assumption coming into this year. So, I think we need to continue to be careful with this business. And in certain segments we will continue to err on the side of caution versus growth, particularly the small group ACA is a good example.

KAREN LYNCH: And, Ana, one of the things that we're doing in the commercial book is we are standardizing a fair amount of our products. We are introducing new exchange through our Bswift acquisition. So, we've got some introduction of new products and capabilities in the marketplace today, and we are seeing some good traction on our commercial business as a result of those products and services.

ANA GUPTE: Got it. Thanks. So, can one assume that even though you don't commit right now to margin expansion in individual you will likely see some? That combined with buyback and the G&A tailwinds from reduced transaction costs potentially -- and, of course, if the Humana deal goes through then all of this moot -- would be enough for you to be very cautious still on your MLR on commercial?

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MARK BERTOLINI: Overall our margins are high single digit, at least 8% in our guidance. So we think that's a really good standard to hold to. People have been waiting for that number to come down for a long time. And I think the diversified portfolio and the way we think about growing the business allows us to maintain that.

ANA GUPTE: Very comforting, thank you.

JOE KROCHESKI: Thank you, Ana. 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 our 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 in the investor relations office. And thank you for joining us this morning.

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