Aetna Inc.

Fourth Quarter 2014 Earnings Conference Call

Hartford, CT

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Prepared Remarks

Tom Cowhey, Vice President – Investor Relations

Good morning and thank you for joining Aetna's fourth quarter and full-year 2014 earnings call and web cast. This is Tom Cowhey, 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 Rohan, Aetna's President will join Mark and Shawn for the Q&A session.

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, including our 2013 Form 10-K, our 2014 Form 10-Qs, and our 2014 Form 10-K, when filed. We have provided reconciliations of metrics related to the Company's performance that are non-GAAP measures in our Fourth Quarter 2014 Financial Supplement and our updated 2015 Guidance Summary, copies of which 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, CEO and President

Good morning. Thank you Tom, and thank you all for joining us today.

This morning we reported full year 2014 operating EPS of $6.70, representing:

- A record result for the company;
- The high-end of our previous annual projection;
- Year over year growth in excess of 7 percent; and
- An Operating EPS CAGR of 15 percent since 2010.

Looking back on 2014, we:

- Solved or priced for nearly $1 billion dollars of new fees and taxes;
- Achieved pre-tax margins in excess of our initial 2014 projections;
- Accelerated Coventry synergies, achieving a run rate in 2014 that will deliver at least $0.90 of operating EPS accretion in 2015, closing out our commitments to shareholders;
- Enrolled nearly 600 thousand public exchange members while exceeding our initial profitability projections in this new program;
- Bolstered our consumer platform through the acquisition of bswift; and
- Continued to advance our efforts to shift the network model toward patient centric population health management.

Our 2014 results are a testament to the strength of our leadership team and the execution of our growth strategy. Underlying these full year results:

- We ended the year with more than 23.5 million medical members, well in excess of our previous projections and representing full year growth of approximately 1.4 million members.
- We reported record operating revenue of nearly $58 billion dollars, including organic growth of approximately 13 percent across multiple lines of business.
- We reported a full year Commercial medical benefit ratio that absent our conservative stance on our ACA compliant block of business and higher than projected flu, would have been at the low end of our previous 2014 projections. Our full year Commercial medical benefit ratio of 80.2 percent was a very good result, as aggregate commercial medical cost trend increases remained moderate and our 51-300 employee block performed consistent with our previous projections
- Our operating expense ratio, excluding the impact of healthcare reform fees and taxes, improved by 100 basis points, as we grew operating revenue and continued to focus on synergy realization.
- Finally, we generated strong cash flow in 2014, which enabled us to continue to invest in our growth strategy, close two acquisitions, pay down debt, increase our shareholder dividend and still repurchase $1.2 billion dollars of our shares.

Our strong finish to 2014, in combination with our strong start to 2015, gives us the confidence this morning to increase our 2015 Operating EPS projection to at least $7.00 per share. As always, this projection does not include any projection of prior year development, and represents approximately 13 percent growth over 2014 results, when prior year development is excluded.

In a moment, Shawn will discuss our 2014 results and 2015 guidance in greater detail, but first I would like to discuss Aetna's growth strategy and how we are executing on that strategy.

At our Investor Conference in December, we highlighted the multiple avenues we have to drive top and bottom-line growth. Specifically we discussed:

- The stability of our large group commercial businesses and the ability of these businesses to continue to produce attractive returns and generate capital;
- The growth of our Government franchise and the potential for sustained growth in the future; and
- The opportunity for additional growth in our individual business as exchanges continue to evolve.

Additionally, we discussed:

- Our continued efforts through Healthagen to transform the network model from one of episodic care to population health management; and
- Our strategy to lead the industry toward a more consumer oriented marketplace.

I will now provide a brief update on how we are executing against some of these growth levers.

Starting with our Large Group Commercial business… 2014 was another solid year, as most of our Large Group Commercial businesses met or exceeded our initial projections. In particular, our fee based businesses had an outstanding year. We grew Commercial ASC membership by over 700 thousand members for the year and exceeded our initial operating projections. These results demonstrate the ability of our Large Group Commercial businesses to continue to generate solid returns and to provide capital to reinvest for the benefit of our customers and shareholders.

Moving on to our Government business… Our Medicare franchise continues to be a key component of our strategy to grow our Government business, and our 2014 results speak to our successes in this business. During 2014, we grew our Medicare Advantage membership by almost 18 percent and our Medicare Supplement membership by nearly 20 percent, results that are well in excess of industry growth. Additionally, we just completed another highly successful Medicare annual election period, where growth exceeded our initial projections. We now expect to grow our Medicare Advantage membership by 90 thousand members in the first quarter, including double-digit percentage growth in our individual Medicare Advantage membership. A key driver of Aetna’s Medicare Advantage membership growth trajectory has been our star ratings, and for the second year in a row, approximately 80% of our sales have come through plans rated 4 stars or greater.

Continuing with Government, our Medicaid business has had an excellent year in 2014. Underlying this strong performance:

- We grew medical membership by over 100 thousand members in 2014, including over 11 thousand members related to our participation in multiple dual eligible demonstration projects;
- We grew premium revenue by over 60 percent; and

- Operating earnings exceeded our initial projections, driven by better underwriting margins in several of our key geographies and strong prior year development.

Looking forward, despite the previously disclosed exit from our Delaware Medicaid contract, we project 2015 to be another strong year of top-line growth for our Medicaid franchise, driven primarily by growth from serving dual eligible and other high acuity populations.

Shifting to public exchanges… We are pleased with our first year execution, particularly in light of the well-publicized challenges with the initial launch of the public exchanges.

We ended the year with approximately 560 thousand on-exchange members, modestly ahead of our most recent projections. Additionally, while the open enrollment period is still on-going, we are on track to exceed our initial enrollment projections for 2015. Further, we have successfully transitioned the vast majority of our off-exchange membership to ACA-compliant plans, consistent with our previous projections. As we look at our total individual business, we now project that we will end the first quarter with approximately 1.1 million members, including up to 800 thousand on-exchange members.

We believe these strong results validate our strategy of focusing on geographies where we have a competitive cost structure and can provide the greatest value to potential customers. As we enter the second year of this emerging marketplace, we are cautiously optimistic on the potential for public exchanges to develop into an attractive growth opportunity, where we can continue to offer value to customers and generate a reasonable return for our shareholders.

Let me now spend a few moments discussing our provider transformation efforts. We continued to advance our strategy of collaborating with providers to build a simpler, more integrated health care system, and we continue to make great strides as we:

- Signed contracts with 28 new ACO partners since year-end 2013;
- Launched multiple new products backed by ACO contracts;
- Doubled our membership covered by value based contracts to more than 3 million members; and
- Increased the percent of our medical costs that run through value based contracts to 28 percent of total spend.

As we continue to focus incentives around improving the health of our members and lowering overall costs, we are moving closer to a health care system that rewards providers for keeping people healthy and ultimately more productive.

Finally, in 2014 we continued to advance our strategy to become a more consumer oriented company. For example, in the fourth quarter we closed the bswift acquisition. This transaction was an important step forward, as it accelerates our efforts to create the leading front-end buy, shop and enroll capabilities necessary to drive the change to a more consumer oriented marketplace. Additionally bswift adds back-end eligibility and benefits administration, an important element for our employer customers as they look to make the transition to defined contribution and private exchange models. Combined with the other investments we have been making, including:

- Our efforts to transform the provider network model through our Healthagen business;
- Our investments in building a new modular administration platform; and
- Consumer facing tools like iTriage; we are not only preparing for the shift to defined contribution and consumer oriented models, we are positioning to drive it.

In summary, as we reflect on the many challenges that we faced as a company and an industry last year, our 2014 results demonstrate strong financial fundamentals and execution against our growth strategies. As we begin 2015, I am confident in:

- Our strategic direction and our ability to execute;
- The multiple growth opportunities ahead that Aetna is well positioned to capitalize on; and
- Our updated 2015 operating EPS projection of at least $7.00 per share.

I would like to thank all of our employees for their dedication in meeting the needs of our customers. By focusing on sound fundamentals, creating new approaches to satisfying customers, and generating and deploying capital responsibly, we believe that we can continue to create value for our customers and our shareholders.

I will now turn the call over to Shawn who will provide additional insight into our fourth quarter and full year results and our updated 2015 outlook. Shawn?

Shawn Guertin – Chief Financial Officer

Thank you Mark, and good morning everyone.

Earlier today we reported full year 2014 operating earnings of $2.4 billion dollars and operating earnings per share of $6.70, results at the high end of our most recent projections and well in excess of our initial guidance for 2014. Aetna's operating results continue to be supported by strong operating fundamentals as evidenced by double digit organic revenue growth, robust cash flow, healthy balance sheet metrics and achievement of target operating margins.

I'll begin with some comments on our overall full year 2014 performance….

- We grew medical membership by approximately 1.4 million members to more than 23.5 million members, ending the year approximately 100 thousand members higher than our previous projection, as a result of stronger than projected December renewals, primarily in Small Group accounts.

- We grew operating revenue by 23 percent to a record $58 billion dollars, driven by double-digit organic revenue growth across multiple lines of business and the full year impact of the Coventry acquisition.
- Our full year Government Medical Benefit Ratio was 84.9 percent, a very good result and a testament to the execution of our strategy to solve for the meaningful rate cuts to the Medicare Advantage program in 2014 combined with continued strong performance of our Medicaid business.
- We improved our full year operating expense ratio by 100 basis points, excluding the impact of ACA related fees, driven by higher operating revenues and continued discipline in controlling costs.
- Finally, we generated over $1.5 billion dollars in dividends from subsidiaries and returned an equal amount to shareholders in the form of shareholder dividends and share repurchases.

Looking more specifically at the fourth quarter results, we grew operating revenue by over 12 percent versus the same quarter last year, to $14.8 billion dollars, driven primarily by membership growth in our Government and Commercial businesses.

From an operating margin perspective, our businesses continue performing quite well.

- Our fourth quarter total Medical Benefit Ratio was 83 percent, a good overall result and a 90 basis point improvement over the prior year quarter.
- Our operating expense ratio increased from the same period last year to 19.7 percent. However, excluding ACA fees from our expenses, our operating expense ratio was essentially flat with the prior year quarter.
- Our pre-tax operating margin was 5.5 percent for the quarter and 7.6 percent for the year, consistent with our target operating margin range. This result represents Aetna's 5th consecutive year of achieving or exceeding this goal, despite an increasing mix of Government and public exchange businesses, and the many challenges that faced our industry in 2014.

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 our Commercial, Medicaid and Medicare products, primarily attributable to third quarter 2014 dates of service.
- Our reserve growth kept pace with premium growth, and days claims payable were 49.2 days at the end of the quarter, down marginally from the third quarter, primarily as a result of processing improvements, but up over 4 days year over year.

Turning to cash flow and capital:

- Operating cash flows remain strong. Our full year Health Care and Group Insurance operating cash flows were 1.5 times operating earnings.
- We also continued to aggressively deploy capital to create shareholder value, repurchasing approximately 3 million shares in the quarter for $243 million dollars and distributing approximately $79 million dollars through our quarterly shareholder dividend.

In summary, our fourth quarter results demonstrate the execution of Aetna's growth strategy, the success of the Coventry integration and the value of our diversified portfolio. I will now discuss the key drivers of our fourth quarter performance in greater detail.

Beginning with our Commercial business… Our Commercial membership declined by approximately 70 thousand members during the quarter, driven by declines in our individual and small group insured books, partially offset by modest ASC membership growth. These results are consistent with our commitment to financially responsible pricing, where we favor margin over membership and price to projected underlying medical cost trends.

Our Commercial Medical Benefit Ratio was 82 percent for the quarter, and 80.2 percent for the full year 2014, a good absolute result and consistent with our previous projections, despite pressures from an early and more severe flu season. Importantly, the medical cost performance of our core commercial business, and specifically our 51-300 employee block, performed consistent with the projections we described on our third quarter 2014 earnings call.

Additionally, Aetna's Commercial MBR was influenced by our continued prudent stance with regard to our ACA-compliant blocks of business. Based on the most recent data available, we have adjusted our accruals related to the "3R's" during the fourth quarter. Specifically:

- We recorded $176 million dollars of incremental reinsurance recoverable during the quarter, bringing our total for the year to $338 million dollars;
- We recorded additional net payables for the risk adjusters of $78 million dollars, bringing the net full year total to $230 million dollars; and
- We did not record any risk corridor receivables as of December 31, 2014. However, in select geographies we have recorded a modest risk corridor payable where our current projections indicate we will be required to contribute to this program. Had we accrued a risk corridor receivable at December 31st, our full year 2014 Commercial MBR would have been lower by approximately 20 basis points.

Consistent with our Commercial MBR performance, Aetna's stand-alone 2014 Commercial medical cost trend was in the middle to upper end of our originally projected range of 6 to 7 percent, in-line with our previous projection.

Moving on from Commercial, our Government franchise is another important growth lever for our business. As Mark mentioned earlier, our Government business had an outstanding year, from both a growth and profitability standpoint, and now represents over 40 percent of our Health Care premiums. Our Government business grew by 45 thousand members in the quarter, primarily due to Medicaid growth of 26 thousand members.

Aetna's continued government membership growth drove fourth quarter Government premiums to $5.4 billion dollars, a 19 percent increase over the prior year period. Our Government Medical Benefit Ratio was 84.4 percent in the quarter, an excellent result in absolute terms and a 260 basis point improvement over the same period last year. Drivers of this year's excellent performance include favorable prior period reserve development, the success of actions designed to solve for the Medicare Advantage funding gap, including the health insurer fee, and continuing strong performance in our Medicaid business.

Finally, Group Insurance operating earnings were $21.3 million dollars in the quarter, compared to $47.9 million dollars in the same quarter of 2013, driven primarily by lower net investment income. For the full year 2014, Group Insurance operating earnings were $171 million dollars, well in excess of 2013 results and our initial full year projections.

Turning to the balance sheet … Our financial position, capital structure, and liquidity all continue to be very strong. At December 31st, we had a debt-to-total-capitalization ratio of approximately 37 percent.

Looking at cash and investments at the parent:

- We started the quarter with $100 million dollars;
- Net subsidiary dividends to the parent were $169 million dollars;
- We repurchased approximately 3 million shares for $243 million dollars and paid a shareholder dividend of $79 million dollars.
- After other sources, we ended the quarter with $100 million dollars of cash at the parent, representing our core liquidity.
- Our basic share count was 349.8 million shares at December 31st.

Moving on to 2015, this morning we increased our 2015 outlook to at least $7.00 per share, up from our previous projection of at least $6.90 per share. As a reminder, Aetna's guidance does not include any projection of prior year development. This increased projection reflects:

- The impact of our recently disclosed preferred drug contract for Hepatitis C treatments on our Commercial members.
- Higher medical membership than we had previously projected driven by our solid finish to 2014 and our encouraging early 2015 growth in both our Public Exchange and Medicare Advantage businesses.
- These two favorable items are partially offset by a projected increase in flu and related costs in 2015, based on the severity of the current flu season.

Our 2015 guidance is further influenced by the following drivers:

- We project that our first quarter medical membership will be approximately 23.5 million members, an increase of approximately 100 thousand members versus our previous guidance. Specifically, Aetna's:
  - Commercial ASC membership is now projected to decline by approximately 175 thousand members, a modest improvement versus our previous guidance;
  - Commercial insured membership is now projected to be flat to slightly down as compared to year-end 2014, influenced by
    - Public and private exchange growth; offset by
    - The previously discussed increase in small group renewal activity that occurred in late 2014, rather than in early 2015; andThe potential for increased attrition in our smaller middle markets and off-exchange individual businesses;
  - Medicare membership is projected to grow by approximately 120 thousand members, comprised of at least 90 thousand Medicare Advantage members and approximately 30 thousand Medicare Supplement members, growth that is again higher than our previous projections; and
  - Medicaid membership is now projected to be better than our previous forecast with other growth almost entirely offsetting the exit from Delaware's Medicaid contract.
- We continue to project full year operating revenue to be at least $62 billion dollars, as the impact of higher than projected membership growth on exchanges and individual Medicare Advantage is projected to be partially offset by the potential for increased attrition in our smaller middle market and off-exchange individual businesses.
- We continue to project our full year Total Health Medical Benefit Ratio to be 82 to 83 percent.
- Aetna's 2015 Core Commercial medical cost trend is projected to be in the range of 6 to 7 percent, reflecting a projected increase in utilization of 50 to 100 basis points over 2014.
- We project our operating expense ratio will be approximately 18 percent. This metric is impacted by the increase in expense related to the ACA fees and taxes, which runs through the SG&A line, increasing the reported SG&A ratio for 2015 by approximately 140 basis points. Our underlying operating expense ratio, excluding these fees and taxes, is projected to show improvement over our 2014 result.
- We project pretax operating margin to be at least 7.3 percent, consistent with our high single digit target.
- We project operating earnings to be over $2.4 billion dollars.
- And, finally, we project net dividends from subsidiaries to be approximately $1.8 billion dollars, as additional capital to support growth is held at the subsidiaries. We continue to project excess cash flow to the parent to be in the range of $800 million to $1.0 billion dollars, noting that increased premiums versus our initial projection could push us into the lower half of this range.

To the extent that current analyst consensus for 2015 contemplates the same quarterly earnings progression Aetna experienced in 2014, especially as it pertains to the first quarter, we would remind investors that the first quarter of 2014 was favorably impacted by severe winter weather and a lower than normal flu season, both of which we do not project to recur in 2015.

In closing, we are very pleased with the strength of our fourth quarter and full year 2014 results. I want to reiterate that our 2015 operating EPS projection of at least $7.00 is a floor, and that we are committed to delivering results in excess of this early view. To that end, we remain focused on:

- Executing on our exchange strategy, both public and private;
- Delivering on our Government growth strategy;
- Improving the performance of our 51-300 employee commercial block of business; and
- Solving for the incremental ACA fees and taxes.

As we continue to execute during this challenging time for our industry, we are confident that we can achieve our 2015 projections and are well positioned to attain our 2018 goals of at least $80 billion dollars in operating revenue and $10.00 in operating EPS.