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CVS - Q1 2019 CVS Health Corp Earnings Call

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OVERVIEW:

CVS reported 1Q19 adjusted EPS of $1.62. Expects 2019 consolidated revenues to be $251.2-254.4b and adjusted EPS to be $6.75-6.90. Expects 2Q19 adjusted EPS to be $1.68-1.72.

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PRESENTATION

Operator

Good morning. My name is Melissa, and I will be your conference operator today. At this time, I would like to welcome everyone to the CVS Health Q1 2019 Earnings Call. (Operator Instructions)

Thank you. Joe Krocheski, Vice President, Investor Relations, you may begin your conference.

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Joseph F. Krocheski - *CVS Health Corporation - Interim IR Officer*

Good morning, everyone, and thank you for standing by. Welcome to the conference call to discuss CVS Health's first quarter 2019 results and outlook for the remainder of the year. As a reminder, this call is being recorded on Wednesday, May 1, 2019.

I'm Joe Krocheski, Vice President of Investor Relations for CVS Health. I'm joined this morning by Larry Merlo, President and CEO; and Eva Boratto, Executive Vice President and CFO. Following our prepared remarks, we'll host a question-and-answer session. Jon Roberts, COO; Karen Lynch, President of Aetna; Derica Rice, President of Caremark; and Kevin Hourican, President of CVS Pharmacy, will also be joining us for the question-and-answer section. (Operator Instructions)

In addition to this call and our press release, we will have posted a slide presentation on our website that summarizes the information in our prepared remarks as well as some additional facts and figures regarding our operating performance and guidance. Our Form 10-Q will be filed later today, and that too will be available on our website once filed.

Please note during this call, we will make certain forward-looking statements that reflect our current views related to our future financial performance, future events and industry and market conditions and forward-looking statements related to the integration of the Aetna acquisition, including the expected consumer benefits, financial projections and synergies. These forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from what may be indicated in the forward-looking statements.

We strongly encourage you to review the information in the reports we file with the SEC regarding these specific risks and uncertainties, in particular those that are described in the Risk Factors section of our annual report on Form 10-K and the cautionary statement disclosures in our quarterly report on Form 10-Q. You should also review the section entitled Forward-Looking Statements in this morning's earnings press release.

During this call, we will use non-GAAP financial measures when talking about the company's performance and financial condition. In accordance with SEC regulations, you can find a discussion of these non-GAAP measures and the comparable GAAP measures in this morning's earnings press release and the reconciliation document posted on the Investor Relations portion of our website.

And as always, today's call is being broadcast on our website, where it will be archived for 1 year following today's call.

Now I'll turn the call over to Larry Merlo. Larry?

Larry J. Merlo - *CVS Health Corporation - President, CEO & Director*

Thanks, Joe. Good morning, everyone, and thanks for joining us. Today, I'm pleased to report that we are off to a strong start to the year, as evidenced by our first quarter adjusted earnings per share of $1.62, which exceeds our initial expectations. The strong performance was driven by all businesses achieving or exceeding what was contemplated at the high end of our guidance ranges, with the Health Care Benefits segment leading the favorability.

Now earlier this year, we provided 2019 adjusted earnings per share guidance of $6.68 to $6.88. And as a result of our Q1 performance, we are raising our full year adjusted EPS guidance to $6.75 to $6.90. This reflects the positive momentum in the business while acknowledging it's early in the year.

We remain singularly focused on driving both near- and longer-term value for our shareholders. And our first full quarter as a combined entity with Aetna was a success on many fronts. We executed smooth January 1 implementations in both the Pharmacy Services and Health Care Benefits segments, posted significant Medicare Advantage membership growth, continued to grow share in our Retail Pharmacy, and we realigned some of our operations to drive greater value.

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In addition to highlighting these operational achievements, I'll provide updates on important operational initiatives that we called out during our fourth quarter call, progress on our integration and transformation initiatives, the 2020 PBM selling season and potential policy changes impacting the Medicare Part D program.

So let me start with the notable progress we made on actions to mitigate the near-term headwinds impacting our business. First, our retail sales momentum remains strong, supported by continued focus on our clinical care programs and network relationships. Adjusted prescription volume for the Retail/Long-Term Care segment increased a healthy 5.5% for the quarter. Additionally, our long-term care business is on track to achieve our targeted margin improvements given our cost management efforts, and we continue to work diligently in driving growth for the assisted living space.

In the PBM, our new Guaranteed Net Cost pricing model continues to garner interest from clients and benefit consultants and will have a small number of clients adopting it this year, and we expect higher adoption in 2020 and beyond. We also embarked on a new effort to reduce costs across our enterprise through improvements in productivity and driving efficiencies across our operations. And Eva will provide details on that initiative shortly.

Moving to our integration of the Aetna business. We are very pleased with the progress we have made. Currently, we are tracking to the higher end of the $300 million to $350 million synergy goal for 2019, and we are on our way to exceed our initial target of $750 million in 2020. And while the synergies are important, the CVS-Aetna combination is about bringing to market new approaches to health care delivery and management.

In our Houston HealthHUB stores, we are demonstrating our ability to bring more health care services into communities, meeting people where they are. We are using our data and analytics capabilities to offer people the next best action to achieve their best health and, in doing so, driving down health care costs. Our vision is for these consumer experiences to be seamlessly connected across digital and clinical interactions, resulting in elements of health becoming part of one's regular routine. The benefits of lower health care costs will have positive financial impacts throughout our enterprise.

These new store formats illustrate how CVS Health is evolving and differentiating to address the changing health care landscape. And while it is early, we are very encouraged by the initial results in our Houston stores. The various product and service offerings are performing at or above our expectations. And given these results, we will expand the HealthHUB model to fill out the Houston market, and we'll provide further details on our rollout strategy next month. But this is the first of many innovations we'll share with you at our Investor Day.

Moving to the 2020 PBM selling season. Our retention rate currently stands in the mid-90%, excluding the impact of Centene. The '20 selling season has been somewhat unusual with no single factor contributing to lower-than-expected retention. And importantly, our service levels and performance metrics remain at historically high levels, and we expect to return to historical retention levels in future periods.

And finally, let me discuss the role of rebates in Medicare Part D and how our part D plans are preparing for the 2020 bid. And I want to begin by acknowledging the clarifying guidance that CMS issued for plan sponsors, that bids should reflect current law and not the newly proposed rebate rule. That guidance also stated that there are a number of issues that need to be addressed before the rule can be finalized. And should a rebate will be implemented, the CMS demonstration project provides plans protection from much of the risk in applying rebates at the point of sale. Additionally, this demonstration project will allow the administration to evaluate in real time the potential impact to Part D members' premiums and to the actual costs that will be incurred by CMS. This is both a prudent step and an important analysis before such a significant change to the Part D program is made permanent. The demonstration project will allow the administration and the private sector to learn together and make adjustments to the Part D program over a more reasonable period of time. And we plan to participate in the demonstration project aided by the learnings from our Allure PDP product.

Now more broadly, the renewed focus nationally on what the next phase of access to affordable quality health care will be has generated significant attention in recent weeks. This is an important discussion, and we will continue to be an active participant. That said, regardless of what shape and form the next stage of health care takes, we remain confident that the private sector will play an essential role in both shaping and executing that next stage. And importantly, we remain best positioned to create and capture new opportunities in this ever-evolving landscape through our local assets, our end-to-end health care offerings and our ability to drive engagement, positively impacting consumer health.

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So let me turn the call over to Eva to walk through the key items for the quarter and an update of our full year outlook.

Eva C. Boratto - *CVS Health Corporation - Executive VP & CFO*

Thanks, Larry, and good morning, everyone. Consistent with prior quarters, you can find a slide presentation posted to our website this morning that provides the details of our first quarter results and the financial statements changes we discussed back in February. First quarter results are reported on a comparable basis, and the reconciliations to GAAP measures can be found in the press release and on the Investor Relations portion of our website. For non-GAAP, keep in mind that we are now excluding amortization of intangibles from our operating income numbers.

I want to reiterate what Larry said. We exceeded the projections we laid out for this quarter, and we're pleased with our 2019 results thus far. Our adjusted EPS was above the high end of our guidance range at $1.62, with all segments performing at or above our expectations and Health Care Benefits leading the way.

Consolidated revenue grew 34.9% in Q1 '19, above the top end of our guidance range. This year-over-year increase was largely driven by a full quarter of managed care operation included this year versus last.

Health Care Benefits, which includes our SilverScript Medicare Part D business, contributed $17.9 billion of revenue for the quarter. Adjusted consolidated operating income grew nearly 57% primarily due to the addition of the Aetna business. The Health Care Benefits segment contributed $1.6 billion to adjusted operating income.

In the PBM, revenue increased 3.1% with adjusted claims up 2.8% versus Q1 of '18, driven by net new business and the continued adoption of Maintenance Choice. PBM adjusted operating income decreased 4.2% as operating margins contracted 20 basis points due to continued price compression and the Anthem investments. Additionally, outstanding rebate guarantees as well as drug price inflation remained consistent with our original expectations.

We released our 2018 PBM cost drug trend report last month. The trends are a validation of the crucial role that we play in the health care system and the value that we provide to our clients and their members in keeping prescription drug costs affordable. Caremark was again successful in delivering on this goal through the use of our formulary and cost management tools. Last year, unit costs for non-specialty medications decreased 4.2% for commercial clients, while we also held unit costs on specialty products to an increase of just 1.7% despite even higher list price increases. Unit cost growth overall was only 1.2% with the total cost trend rising 3.3% due to increased utilization, including improvements in adherence. And importantly, we were able to drive down the average out-of-pocket costs for plan members for the sixth year in a row, helping patients stay adherent and improving overall health.

In Q1, the Retail/Long-Term Care segment performed better than expected. We delivered strong adjusted script growth with adjusted same-store script growth of 6.7% despite the weaker flu season. This was driven by the continued adoption of our Patient Care Programs, collaborations with PBM and preferred status in a number of Medicare Part D networks.

Our market share in Q1 stands at 26.2%. Additionally, front store comps increased 0.4% despite the shift of the Easter holiday to later in April, which was approximately an 80 basis point headwind.

As expected, first quarter Retail/Long-Term Care adjusted operating income declined 18.9%. The year-over-year decline was driven by factors we've previously discussed, including continued reimbursement pressure with fewer offsets; higher expenses reflecting the wrap of last year's investments using savings from tax reform; and year-over-year performance of our long-term care business. Additionally, we incurred higher legal costs in the quarter.

As we have discussed before, we are continuously looking for ways to optimize our asset portfolio. In doing so, we made the decision to close 46 underperforming retail pharmacy locations. We reported a $135 million charge in the Retail/Long-Term Care segment in Q1 related to the store closures, primarily representing the operating lease right-of-use asset impairment charges. Consistent with our non-GAAP definition, this charge is excluded from our non-GAAP metrics.

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And finally, Health Care Benefits started off the year strong with revenue and adjusted operating profit ahead of our expectations. Underlying these results, we grew to serve over 700,000 additional medical members in the quarter, driven by strong Medicare Advantage and commercial ASC membership growth and the initiation of new Medicaid contracts in Kansas and Florida.

Our total health MBR was 84% in the quarter, a good start to the year. The MBR reflects moderate medical cost trends and favorable prior year reserve development across all of our core products.

As a reminder, given the timing of the close of the Aetna merger, the year-over-year results are not comparable for our Health Care Benefits segment.

Our days claims payable was 45 days for Q1, which is lower than historical Aetna results. This difference was driven by the inclusion of SilverScript's operations, which lowered the metric by about 5 days given faster claims submission times.

Going below the adjusted operating income line, our interest expense and weighted average shares were in line with expectations with a slightly lower income tax provision.

We generated strong cash from operations this quarter of $1.9 billion. We repaid nearly $900 million of long-term debt in the quarter, which includes $375 million of long-term notes that matured and $500 million of the term loan outstanding using available cash to reduce long-term debt and interest expense. In the quarter, we also delivered more than $600 million to shareholders through dividends.

It's important to note that our commercial paper balance was temporarily elevated at the end of the first quarter given timing of customer receipts. That balance was fully paid off on April 1. And since quarter end, we have maintained an average commercial paper balance of less than $200 million. Taking all of this into account, since the close of the transaction, we have repaid approximately $4 billion of debt.

Turning to our 2019 guidance. As Larry said, we are raising the guidance range to account for favorable performance during the first quarter. This brings our full year adjusted EPS range to $6.75 to $6.90. We now expect consolidated full year 2019 revenue in the range of $251.2 billion to $254.4 billion and adjusted operating income between $15 billion and $15.2 billion.

For the segments, we expect full year 2019 adjusted operating income in the Pharmacy Services segment to be in the range of $4.86 billion to $4.92 billion, the Retail/Long-Term Care segment in the range of $6.63 billion to $6.71 billion and the Health Care Benefits segment in the range of $5.18 billion to $5.24 billion.

Our outlook for each of the segments was updated given the outperformance in the first quarter. The factors affecting the year have not materially changed from what I discussed back in February, which are summarized in the slides we posted on our website this morning. Recall that both the deal synergies and the incremental investments are expected to disproportionately affect the Health Care Benefits segment.

As Larry said, we are tracking to the higher end of the synergy range for this year and are on track to exceed our target of $750 million in 2020. These synergies will stem from the elimination of duplicative corporate and operational functions, purchasing efficiencies and some medical cost savings, including formulary alignment.

As we discussed on our February call, we are also making investments to achieve our longer-term goals. These investments center on digital enhancements and the development of new programs to accelerate growth. We continue to expect incremental investment spending to be between $325 million and $350 million in 2019. In addition, we also continue to expect integration costs of approximately $550 million, which are excluded from our non-GAAP guidance metrics.

Our cash flows are expected to remain strong this year, delivering between $9.8 billion and $10.3 billion of cash flow from operations, of which we expect $4.2 billion to $4.6 billion to be available for debt repayment this year. In addition to paying down our 2019 maturity, we plan to pay down the rest of our term loan by year-end.

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The cash from operations will be reduced by net capital expenditures of approximately $2.3 billion to $2.6 billion and shareholder dividends of approximately $2.6 billion after increased retained capital needs for our insurance subsidiaries commensurate with our strong year-to-date membership growth in the Health Care Benefits segment, particularly in the government space. As I stated, we expect to have $4.2 billion to $4.6 billion available for debt paydown in 2019.

We are laser-focused on improving the cash generated by our business. And as we have discussed previously, we are working on a number of initiatives to further improve our cash generation, which would yield upside to our current projections.

Turning to operating efficiencies. Both CVS and Aetna have had a strong history of executing successful cost reduction and productivity initiatives. And through our integration, we are seeing the opportunity to make productivity gains across the enterprise. We have consolidated various programs across the enterprise into one enterprise modernization initiative. We expect the savings and productivity gains this initiative generates to help offset the competitive dynamics we are experiencing, drive the creation of more affordable products for our customers and provide capacity that will help us achieve our financial targets as we continue investing in our strategic and transformational initiative.

We are confident that this initiative will help drive longer-term growth in the combined business beyond 2019. We expect this initiative to generate run rate savings of $1.5 billion to $2 billion in 2022, and this is over and above our deal synergy targets.

Finally, I want to touch on expectations for earnings progression for the rest of the year. Year-over-year growth of consolidated adjusted operating income will be highest through the first 3 quarters as we wrap the addition of Aetna. We expect to see adjusted operating income growth in our Retail/Long-Term Care and PBM segments improving as we move throughout the year. Adjusted operating income within Health Care Benefits is expected to be greatest in Q1 and lowest in Q4. For Q2, we expect adjusted earnings per share to be in the range of $1.68 to $1.72.

With that, I'll turn the call back to Larry.

Larry J. Merlo - *CVS Health Corporation - President, CEO & Director*

Thanks, Eva. We are pleased with the progress and momentum we demonstrated in the quarter as we position ourselves to win in this evolving health care landscape. The breadth of our assets, capabilities and experience meaningfully differentiate us from others in the market and provide us unique opportunities to create a company that generates superior value for shareholders and all the constituencies we serve.

Next month, we plan on sharing our long-term targets, including more specific details on the innovative products and services we plan to bring to market to achieve those goals as well as our earnings, cash flows and debt targets. And we look forward to seeing many of you in New York City on June 4.

So with that, let's go ahead and open it up for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Lisa Gill from JPMorgan.

Lisa Christine Gill - *JP Morgan Chase & Co, Research Division - Senior Publishing Analyst*

Congratulations on the first combined quarter. Larry, let me start with the selling season. I know you said that there wasn't anything specific to the losses that you've seen thus far for 2020. But if I look at, at least what The Street knows about, it looks like they're primarily coming on the health

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plan side. So do you think that now that you own Aetna, that's playing anything into those decisions around health plans doing business with CVS? That would be my first question.

And then secondly, as we think about that health plan business as it relates to your retail business, can you just talk about utilization as far as script goes? Do you -- are you seeing a lot of those scripts coming through CVS? Or will we see a combined loss of both of those going into 2020?

Larry J. Merlo - *CVS Health Corporation - President, CEO & Director*

Yes, Lisa, and I'll take the first part of the question. Lisa, what's interesting is we've just had our Caremark Client Forum a few weeks back. Several of us were there. We spent time with the broader audience as well as our advisory groups, which we have that for each discipline within Caremark. And I would describe the health plans as having an ongoing tremendous amount of interest in terms of what it is that we're doing around transformation and interest in terms of how that can create value for them.

So I did not get any sense whatsoever that this notion of channel conflict is entering into the selling season or entering in as a concern. And actually, quite the opposite, wanting to understand where we're at with the transformation and when and how they can benefit from those innovative products and services.

Eva C. Boratto - *CVS Health Corporation - Executive VP & CFO*

And Lisa, this is Eva. On your second part of your question, I would say, as you know, our retail business has worked very strong over the last couple of years to improve our relationships with other payers and have constructive network offerings. So we'll continue to work on and develop those relationships and don't see anything meaningfully step back there.

Operator

Your next question comes from the line of Ross Muken from Evercore.

Ross Jordan Muken - *Evercore ISI Institutional Equities, Research Division - Senior MD and Head of Healthcare Services & Technology*

Congrats. So I guess maybe on the retail, side, I mean it seems like the HealthHUBs, and I recently saw one myself down in Houston, are pretty impressive new institutions. I'm trying to get a sense -- and I don't want to steal too much from the Analyst Day, but just in terms of the progress you've made there and the feedback, the sort of loop of figuring out what models work, what don't, the sort of traffic uptick. So I guess when -- maybe less on sort of anything numerical, but when do you think you'll be able to give us sort of updates on rollout, sell-through to sort of the Aetna member base, other creative sort of solutions you can come up with, if any, on the Medicaid side? Just a better sense of how that sort of plan is going to evolve and then how you're able to sort of incorporate that with some of the other omnichannel things you're doing as well as some of the front-end refresh overall?

Larry J. Merlo - *CVS Health Corporation - President, CEO & Director*

Ross, it's Larry. Great question, and I'll take the first part, and then I'll ask Kevin to comment perhaps to your point about -- it's difficult to talk quantitatively at this point because we still have a limited amount of time, but I'll ask Kevin to talk qualitatively in terms of what we're seeing, what we're hearing from those that we're serving.

Ross, I would describe where we're at today as we got more things right in our concept of what a HealthHUB is, then things that we missed. And there are some things that we're tweaking, but as you heard in our prepared remarks, we're ready to complete the Houston market in the coming weeks. And to your other question, we will have a more detailed view of the rollout strategy beyond Houston as it relates to this year as well as 2020.

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So bottom line, as you heard in our remarks, we are excited about the opportunity.

Kevin Hourican - *CVS Health Corporation - Executive VP & President of CVS Pharmacy*

Yes, Larry. Thanks, Larry. It's Kevin. And I appreciate the question. We call it creating a compelling place to shop, a reason for the consumer to want to come into the store. And that HealthHUB format is achieving that objective. The consumer reaction has been quite strong. We've added thousands of net new items to the front store in the self-care and wellness arena, expanded MinuteClinic services. We've expanded the pharmacists' interactions with patients with greatest needs.

And last but not least, we're really intrigued by the addition of a new position in our store called the care concierge, which is the glue that's kind of pulling together these ecosystems that can help answer consumers' questions about any and all health care needs that they have, including health care benefits in partnership with Aetna and other health plans in the future.

And as Larry said, at our Analyst Day, we'll talk in more detail about the expansion plan. We're working aggressively on that as we speak and can share those details on June 4.

Larry J. Merlo - *CVS Health Corporation - President, CEO & Director*

Ross, the -- maybe just wrapping up this topic, one of the things that we are learning that I know is of interest is, out of the gate, we've talked about our hub-and-spoke concept. So if you look at what does it take to complete the Houston market, we needed about another 20 stores, which would represent about 15% of the stores in that metroplex, if you will. So we are learning how to build out this hub-and-spoke concept, acknowledging that there are things that we're learning in these stores that we will apply broadly to the stores that aren't hubs in the market.

And again, as Kevin mentioned, we'll talk more about that at -- on June 4. But again, the things that we are measuring, the metrics that we're using internally, we're very pleased. They're all meeting the objective or ahead of our target.

Kevin Hourican - *CVS Health Corporation - Executive VP & President of CVS Pharmacy*

So just last comment. This is Kevin again. You asked about omnichannel. We recently announced that we expanded home delivery same day to over 6,000 stores in partnership with Shipt, and we're pleased to see consumer adoption to even more convenient home delivery.

Ross Jordan Muken - *Evercore ISI Institutional Equities, Research Division - Senior MD and Head of Healthcare Services & Technology*

And I guess maybe on the benefits business, I mean it seems like you've done obviously quite well coming into this year on membership. You had momentum there. As you think about other types of places to integrate the asset base and maybe deeply tie in also sort of what you're doing on Caremark, I guess is there anything like anecdotal, as you've integrated and as you've sort of game-planned, again maybe at a very high level and you'll share more detail at the Analyst Day, but things where, well, we wouldn't have thought we can do that or an area of focus where you think you can really sort of move the needle as you start to laser in on maybe some of these bigger cost opportunities that exist within that sort of cost base?

Larry J. Merlo - *CVS Health Corporation - President, CEO & Director*

Well, Ross, 2 points on -- to that question. Kevin mentioned the care concierge. And we're gaining a tremendous amount of learnings in terms of what exactly our customers are looking for based on the interactions this position is having with them. And it covers a wide range of topics.

I think the second thing is there is certainly a lot more that we can do around specialty based on some of the things that we're seeing and learning.

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And the third thing, Ross, that I would mention is that we've got -- you've seen one of the concept stores, but as you think about the various segments that we serve, we could see a HealthHUB that is modified from what you may have seen in Texas that would play to that segment of beneficiaries but recognizing that they have different needs than what we may see more broadly in a market.

So those are some things that we're working on as well.

Operator

Your next question comes from the line of Anagha Gupte from SVB Leerink.

Anagha A. Gupte - *SVB Leerink LLC, Research Division - MD of Healthcare Services & Senior Research Analyst*

Yes. Glad that you had a good quarter. I wanted to get some color on what the potential would be for growth in 2020. And I obviously am not looking for guidance or anything. But if you take a look at your synergy guidance, which you're saying confidently is above $750 million, and it sounds like there's some enterprise savings building on top of that now, the Anthem story should become positive, offsetting some of the standard G&A pressures. And even though you have Centene, maybe they kind of cancel out, maybe net positive. The PBM brand inflation guarantee sounds like that is tapering off, and the Omnicare headwind should get better. So when I look at the headwinds offsetting that, that could be retail margin pressure, PBM margin pressure, but on balance, where do you see -- I mean do you think around this close to $7 EPS handle now in '19 you can go into '20?

Larry J. Merlo - *CVS Health Corporation - President, CEO & Director*

Yes. Ana, it's Larry, and we appreciate the question. As you were just ticking off, there are certainly a lot of moving parts as it relates to 2020. And as you heard in our prepared remarks, the point of today's discussion, in light of Investor Day that is a month away, is really to zero in on our Q1 results, our outlook for '19. We understand and appreciate the questions that are out there beyond '19, and I can assure you that next month, we'll share our near-, our long-term targets, including the details on how we achieve those targets on June 4.

Anagha A. Gupte - *SVB Leerink LLC, Research Division - MD of Healthcare Services & Senior Research Analyst*

Okay. Then maybe just if I can ask on the quarter and follow up on the margins in retail. I mean you've come now in line. You've exceeded your original guidance at least on the revenue. And then on the PBM margins, how do you see that shaping up for the industry as a whole into the selling season for the PBM? And in retail, with your ability to steer Aetna into your CVS network, does that give you an edge that can offset some of the secular pressures?

Eva C. Boratto - *CVS Health Corporation - Executive VP & CFO*

This is Eva. I'll try to break apart your questions there. Overall, for both of the legacy businesses, retail and PBM, our margins, our performance came in at or better than expected. And some of the headwinds that we outlined, whether it was inflation, the rebate guarantees, some of the challenges with long-term care, we performed certainly within our expectation. As we said, longer term, as we think about the store, right, moving toward providing more services and greater opportunities, higher value, we see those as the opportunities to improve our margins and our performance in that business.

Operator

Your next question comes from the line of Ricky Goldwasser from Morgan Stanley.

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Rivka Regina Goldwasser - *Morgan Stanley, Research Division - MD*

Congrats for a good start for the year. My question is around the cost savings that you identified, $1.5 billion to $2 billion. Should we think about these as net cost savings or gross? And how should we think about the cadence to 2022? And are most of these cost savings coming from the retail segment? Or are they more broadly achievable throughout the enterprise?

Jonathan C. Roberts - *CVS Health Corporation - Executive VP & COO*

So Ricky, this is Jon. So this modernization effort that we're talking about is -- it's a transformative program that's comprised of initiatives including the work already underway for integration, the business unit productivity programs that we traditionally work on and then initiatives that are enterprise-wide as our companies have come together. And we're calling that long-term value or LTV initiatives. And there's 4 core pillars of this program, and I'll just give you a couple of examples.

First is we want to share simplicity and at the same time deliver cost -- substantial cost benefits, and we want to do that while improving our consumer experiences. So within that broader effort, these enterprise initiatives take advantage of the combined company's unique capabilities and assets while helping us accelerate our savings goals. So some examples of these opportunities include call centers, digitalization of shared services, demand management and rationalization of our IT infrastructure.

So this is a multiyear effort. These are net savings numbers. And we'll talk more specifically about this at our Analyst Day on June 4.

Operator

(Operator Instructions) Your next question comes from the line of Ralph Giacobbe from Citigroup.

Ralph Giacobbe - *Citigroup Inc, Research Division - Director*

You called out a favorable prior year and specifically 4Q and then provider recoveries. I was just wondering what the provider recoveries relate to, the size of those and over what period of time.

Eva C. Boratto - *CVS Health Corporation - Executive VP & CFO*

This is Eva. In terms of the prior period development, consistent with Aetna legacy practices, there was no prior period development included in our guidance. Overall, we experienced favorable development across all of the core businesses, as I said in the prepared remarks. And from a magnitude perspective, you can think about it as consistent year-on-year with development last year.

Was there another question, Ralph? In terms of, I think, your question also maybe around the settlement with HCA, that was taken into account in some of our initial accounting with the acquisition and is not reflected in our results.

Operator

Your next question comes from the line of Ann Hynes from Mizuho Securities.

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Ann Kathleen Hynes - *Mizuho Securities USA LLC, Research Division - MD of Americas Research*

So since last earnings, I think the question I get most from investors is on the retail operating profit. Walgreens reported obviously since you reported, and they had similar results. And a lot of investors ask me if this is the new norm. So can you just talk about what you think can happen in the market or what headwinds will ease over the next couple of years to stabilize the operating profit trajectory of this business?

Eva C. Boratto - *CVS Health Corporation - Executive VP & CFO*

It's Eva, I'll start, and Kevin will jump in, in terms of longer term. As you look at our Q1 results, the headwinds are very consistent with what we described as we provided our guidance. Over half of the contraction was attributable to the tax reform investments, our long-term care as well as the incremental tax expense that we cited in this quarter. As you think about the tax reform investments, those subside. We are -- those are completed and in the run rate as we get to the back part of the year. We do expect Omnicare performance to improve as we go forward, and we do expect generics to improve next year in the near term although won't be a tailwind as you think about longer term. And we continue to see opportunities to drive services in our stores and increase products as an opportunity to mitigate the traditional headwinds.

Kevin Hourican - *CVS Health Corporation - Executive VP & President of CVS Pharmacy*

And Eva, Kevin -- thank you. This is Kevin. I'll just build on that on the longer term. We will talk about this more on June 4. But if you think about the opportunities to improve profitability in the upcoming years, think about it in a 5-part plan. First is drive industry-leading comp store script growth in our clinical adherence programs and increased medication adherence in script drug. Second is cost of goods sold improvement through Red Oak Sourcing. Third is to improve retail productivity through automation and process improvement. Fourth, as we talked about briefly on the last call, a new contracting approach that aligns our incentives for reimbursement through lower overall medical costs and sharing those savings. And lastly, we're seeing optimistic things in our front store business through health and beauty sales and profit growth that are drawing more customers into our store.

Eva C. Boratto - *CVS Health Corporation - Executive VP & CFO*

And I'll just wrap up with one more thing. Obviously, the costs, the enterprise modernization initiative that Jon spoke to, will benefit all aspects of our business.

Operator

Your next question comes from the line of Justin Lake from Wolfe Research.

Justin Lake - *Wolfe Research, LLC - MD & Senior Healthcare Services Analyst*

First, just last quarter, you gave us some color on rebate guarantees. Wanted to come back to that just in terms of I think there was a little confusion around whether -- or do rebate guarantees actually get better year-over-year? I know eventually, they'll unwind and you'll renegotiate these contracts with less guarantees in them. But does it get better next year, meaning positive year-over-year? Or is it just less negative year-over-year?

Derica W. Rice - *CVS Health Corporation - Executive VP & President of CVS Caremark*

Justin, this is Derica. What we stated was that the rebate exposure will peak in 2019 and then that exposure will begin to dissipate over the ensuing years. So we expect that exposure to get less in 2020 and 2021. And so far this year, it's pretty well within our expectations that we laid out within our guidance.

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Operator

Your next question comes from the line of Steven Valiquette from Barclays.

Steven James Valiquette - *Barclays Bank PLC, Research Division - Research Analyst*

So maybe somewhat similar to a couple of the other questions. For the PBM business, just given all the discussion around rebate minimum guarantees, cost guarantees, et cetera, I was kind of curious at a high level just around the Anthem customer contract. Without giving any numbers, just qualitatively only, does CVS already have strong visibility internally on what the profit contribution is likely to be from this contract in 2020? Or conversely, just given all of the discussion around guarantees that are baked into many contracts now, could there still be high volatility either up or down for CVS' profits from this large contract in 2020?

Derica W. Rice - *CVS Health Corporation - Executive VP & President of CVS Caremark*

This is Derica again. That's a great question. We appreciate it. When we provided our color commentary regarding rebate guarantees and our exposure, that included Anthem as well. So when I talked about our exposure peaking in 2019 and then subsiding in ensuing years, that factored in our Anthem contract as well.

Larry J. Merlo - *CVS Health Corporation - President, CEO & Director*

The other thing, Steve, to keep in mind, and I think you heard this on Anthem's call last week, that the vast majority of that conversion takes place in the second half of this year to include the Medicare business converting on 1/1/20.

Eva C. Boratto - *CVS Health Corporation - Executive VP & CFO*

And Steve, the only additional piece I'll add on that, as you think about when we onboard large health plans, the margins tend to be thinner earlier in the contract period as we execute on our programs and initiatives to drive improvements in the overall margins and profitability.

Operator

Your next question comes from the line of Robert Jones from Goldman Sachs.

Robert Patrick Jones - *Goldman Sachs Group Inc., Research Division - VP*

I guess just 2 quick ones, one on the PBM side. Of the $47 billion I think you guys highlighted that was up for renewal this year, how much is left to still be renewed?

And then just on the Aetna side of the business, I'm curious if you would just share how the performance would have compared to internal expectations if not for the prior period development in the quarter.

Larry J. Merlo - *CVS Health Corporation - President, CEO & Director*

Bob, it's Larry. I'll take the first part. And Bob, we had said we have $47 billion up for renewal. We're just over halfway through the renewal season. It's pretty consistent with where we would have been at this point in time with prior years.

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Eva C. Boratto - *CVS Health Corporation - Executive VP & CFO*

And in terms of Aetna overall, underlying, the business performed well including the prior period development. It's early in the year. We -- recall, we onboard a lot of new memberships, so we're monitoring that claim activity very, very closely. But I would say, on all fronts, we're pleased with Aetna's performance.

Operator

Your next question comes from the line of Glen Santangelo from Guggenheim Securities.

Glen Joseph Santangelo - *Guggenheim Securities, LLC, Research Division - Analyst*

Larry, just wanted to shift gears a little bit and go back to the Retail/Long-Term Care segment. Your scripts in that segment were up 5.5%, which is a little bit stronger than expected particularly given we had a weaker-than-expected flu season. And so I'm kind of curious if you could dive into that a little bit more and give us a sense for maybe what drove that trend. I'm guessing it's kind of too early that it's related to the benefits from the acquisition, but anything you can give us on the sustainability of that trend and what drove that will be helpful.

Kevin Hourican - *CVS Health Corporation - Executive VP & President of CVS Pharmacy*

This is Kevin. It's a good -- appreciate the question. Think about our script growth coming from 3 components. One is network relationships, the third-party payer contracts which are contributing to growth.

The second is organic growth through our clinical adherence programs. So by keeping a patient adherent to their medication therapy, it helps them on their path to better health, and it drives our business. We're doing very well on those clinical programs, and we see sustainability of that growth.

And then the third piece would be new services. We've introduced some compelling new unique services, like our Saving Patients Money program, multi-dose packaging and home delivery, as I spoke to earlier. And we're seeing some nice growth in those newer services that we've brought to the market.

Larry J. Merlo - *CVS Health Corporation - President, CEO & Director*

So Glen...

Operator

Your next question comes from the line...

Larry J. Merlo - *CVS Health Corporation - President, CEO & Director*

I was just going to say, Glen, we see those in terms of being foundational and not episodic in nature.

Operator

Your next question comes from the line of Charles Rhyee from Cowen.

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Charles Rhyee - *Cowen and Company, LLC, Research Division - MD and Senior Research Analyst*

Just staying with the retail segment for a second here. One of your competitors on their call a couple of weeks ago kind of cited generic deflation or the moderating effect of generic deflation as a factor in some of their results. I haven't really heard you guys talk about that. Can you talk about sort of the -- what you're seeing in terms of moderating generic deflation? Because it looks like that trend has been continuing to moderate through March. And how are you kind of thinking about the environment here as we move forward for that?

And is that -- and I guess related to that, is that already baked into your guidance when you talked about sort of you look at the 10% down, with half of it being from -- partly from generics. My assumption had -- my thought had been that you would really be referring more to the prevalence of the break-open generics and not necessarily generic deflation. If you could just provide some color on that, that would be great.

Eva C. Boratto - *CVS Health Corporation - Executive VP & CFO*

Yes. This -- Charles, this is Eva. In terms of what we're seeing as it pertains to generics, it is all included in our guidance. And as we outlined back in February, what we're seeing is overall fewer opportunities with break-open generics this year. It is a lighter year relative to the prior years than what we've seen, and we see it improving in 2020.

Jonathan C. Roberts - *CVS Health Corporation - Executive VP & COO*

And then, Charles, the only thing I would add is -- you've heard a lot of talk about the improvements in the FDA process that allows suppliers to more rapidly get to the market. That gives us more flexibility. And so we are seeing less opportunity in '19, as Eva said, but we think Red Oak continues to deliver value for us, significant value for us, and we expect that to be even better as we move forward.

Operator

Your next question comes from the line of A.J. Rice from Crédit Suisse.

Albert J. William Rice - *Crédit Suisse AG, Research Division - Research Analyst*

Obviously, the last few years, one of the bright spots for Aetna was the growth in MA. And as it's come on board with you guys, Medicare Advantage enrollments accelerated. I wonder if you could just parse out a little bit how you're seeing that growth this year. Is that expanding geographies, which was part of the story the last few years? Or is it market share gains? And I know the rule of thumb on Medicare Advantage. In the first year, those members typically come on at sort of a break-even level. Is that what you're assuming? Or is there any reason to think you guys might be able to bring them on more profitably or not?

Karen Sue Lynch - *CVS Health Corporation - Executive VP & President of Aetna*

It's Karen. I would characterize our Medicare Advantage growth coming from a number of places. One, yes, our services area expansion has generated a fair amount of growth for us, but I would also say that we are continuing to grow in our existing footprint and that our same-store growth has generated good Medicare Advantage growth for us.

I would also tell you, our continued excellence in Star is helping the performance of this product. And we've also been strengthening our clinical management activities, which I think has been resonating in the marketplace. I would also look to the product and product flexibility and our zero-premium plan, which has allowed us to grow this year as well. And then we have been very strongly managing our distribution channels. And I would say it's the combination of all those factors that are really driving it.

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Relative to the margin, what I would say is we are tracking in line with our expectations. We typically expect to see lower margins on first-year business, but there's nothing in our metrics that give us any pause for any deterioration. And I would just say that we're in line with what we expected on margins.

Operator

Your next question comes from the line of Eric Percher from Nephron.

Eric R. Percher - *Nephron Research LLC - Research Analyst*

Eric Percher and Josh Raskin from Nephron. Larry, you sound more constructive on the safe harbor proposal after the CMS guidance and the demo announcement. Obviously, there's a lot of potential unintended consequences. As we looked at your comments, there was a comment toward the end around disallowing of pharmacy purchase discounts, which would appear to impact you as a buyer and dispensing pharmacy. So I wanted to ask, is that material in your view? And what action do you take to try to offset that if it occurs?

Larry J. Merlo - *CVS Health Corporation - President, CEO & Director*

Well, Eric, let me make sure I'm following your question because as we have talked about rebates, we have always provided an all-in number as it relates to rebates. And so we don't see any issues there or misalignments. If I'm following your question, what we have talked about is we see rebates as a form of discounting. And we can get into a lot of discussion around how that has brought the net price of pharmaceuticals down for the clients and members that we serve.

And if you look at rebates as discounts, what we emphasize is through the private sector, there has been a lot of good things happen in that regard. And rebates can take some other form, but we must make sure that the private sector competition that results from that, that drives down price, that the ability to -- for that to continue in the form of some type of discounts doesn't go away.

Operator

Your next question comes from the line of Kevin Caliendo from UBS.

Kevin Caliendo - *UBS Investment Bank, Research Division - Equity Research Analyst of Healthcare IT and Distribution*

One quick question on the prior year development. I just -- I know it wasn't contemplated in the original guidance, but in the updated guidance, is there any incremental prior year development built into those numbers? That was the first one.

And then the second one, on the PBM side, historically, when we've seen companies with low retention, a lot of times they've been able to offset some of the losses by dipping down into the mid-market and maybe taking some share there. Is there a similar strategy or something you can do to offset the headwinds for 2020 on the PBM side strategically?

Eva C. Boratto - *CVS Health Corporation - Executive VP & CFO*

So I'll take the first question, Kevin, regarding prior period development. The only thing that is reflected in the numbers we presented today was the prior period development realized in Q1. No projections go forward consistent with our initial guide and legacy Aetna practices.

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Larry J. Merlo - *CVS Health Corporation - President, CEO & Director*

And Kevin, it's Larry. In terms of the second question, Kevin, while we provided an update on the selling season as it stands today, obviously, there's still a lot of runway remaining for the 2020 selling season. And we'll continue to provide updates. So we still have a long way to go before we complete the season.

Operator

Your next question comes from the line of Peter Costa from Wells Fargo Securities.

Peter Heinz Costa - *Wells Fargo Securities, LLC, Research Division - MD and Senior Analyst*

Question on the Health Care Benefits business and your maintained guidance on medical benefits ratio of 84%. Given the favorable prior period development, you'd think you'd be sort of on the lower end of that range at this point in time. Can you -- would you say that you're at the lower end of the range at this point? Or do you think really it's the full range that you're thinking about? And then will you not have the seasonal pattern that Aetna typically had, which was a rising medical loss ratio through the year because of all the deal synergies?

Eva C. Boratto - *CVS Health Corporation - Executive VP & CFO*

It's Eva. It's early in the year, so we provided the range, and we'll stick with that range. Obviously, as we progress throughout the year, we'll provide additional updates. There was a lot of membership growth, as Karen cited, which we'll continue to monitor their utilization.

In terms of the progression throughout the year, as we stated, we moved SilverScript over to the Health Care Benefits segment, which carries a different quarterly pattern than the traditional Aetna pattern, where on the SilverScript, it's highest in the first quarter and reduces as you go throughout the year given the risk corridor sharing. So that's a key driver of why you see maybe a little bit of a higher-than-expected Q1 MBR.

Operator

Your next question comes from the line of Michael Cherny from Bank of America Merrill Lynch.

Michael Aaron Cherny - *BofA Merrill Lynch, Research Division - Director*

Larry, I want to go back to a comment you made earlier regarding your recent PBM user meeting and the conversations you were having with health plans and the engagement level. I guess as they think about what you're becoming as an integrated entity now that you own Aetna, what are they looking for you, the new CVS, qualitatively to provide for them? And that engagement push, is there a realization or understanding of what you're doing with the store base and with the HealthHUB, initial push that can help them drive potential value going forward?

Larry J. Merlo - *CVS Health Corporation - President, CEO & Director*

Yes, Mike. First of all, we -- as part of that meeting, we did provide an update as to the work today to include the HealthHUBs. And I would say that there's a growing realization that if we describe this as consumerism in health care is here to stay. So the fact that we have these customer-facing assets is, I think, what is gaining a lot of interest and attention in terms of what that potentially can mean.

And it reflects some of our earlier discussions, some of the points that Kevin made, that as you think about -- if I just focused on the bricks-and-mortar retail store for a minute, that we're beginning to see this evolution through the HealthHUBs of it's not just selling thousands of products. It's a combination of products and services, that the dynamic in health care at some point, even though we're seeing more and more health care in the

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palm of your hand, and that's an important part of our strategy, at some point, that consumer has to be touched. And we have the unique way to do that in a surround-sound way.

Operator

Your last question comes from the line of Hima Inguva from Bank of America.

Hima B. Inguva - *BofA Merrill Lynch, Research Division - Director*

Congrats on a good quarter. Eva, just wanted a little bit of clarification on the pace and cadence of delevering that you expect. Maybe if you could share the timing on when you see getting to the 3x leverage target and then also any color on your recent conversations with the credit rating agencies would be great.

Eva C. Boratto - *CVS Health Corporation - Executive VP & CFO*

Yes. Thanks for the question, Hima. As we said consistently, our top priority is to deleveraging, get to our low 3x rating. We're pleased with our paying down the term loan early, $500 million we paid in Q1, and we expect to pay that full term loan down by the end of the year. And at this point, I -- we're not going to provide our longer-term leverage road map there. We'll provide that at Analyst Day.

That said, as we continue to look for opportunities to generate cash to pay down this debt, and we're working on initiatives on working -- improving working capital, a full review of our portfolio as well as the cost initiatives that Jon spoke about, we believe, in addition to driving growth in our business, will enable us to continue to improve our leverage.

Larry J. Merlo - *CVS Health Corporation - President, CEO & Director*

So just wrapping up here, there were a lot of questions. We appreciate all the questions. We're trying to track to make sure we've answered everything, recognizing there were multiple pieces to questions. One of the things that I do want to clarify, I think Ricky had asked the question about the enterprise modernization, the cost reduction, where the numbers gross or net. And we want to be clear that those numbers that Eva provided were after any expenses incurred to execute that. So those were net improvement numbers.

And listen, obviously, Joe and his team are available for follow-up. And we look forward to hopefully seeing all of you on June 4.

Operator

Ladies and gentlemen, this concludes today's conference call. You may now disconnect.

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