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Event Details

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Company: CVS Health Corp.
Ticker: CVS-US

Company Participants

Shawn M. Guertin - CVS Health Corp., Chief Financial Officer & Executive Vice President

Other Participants

A. J. Rice - Analyst

MANAGEMENT DISCUSSION SECTION

A. J. Rice

Hello, everyone. I'm A. J. Rice, the healthcare services analyst at Credit Suisse. We're very pleased to have up next in the room, CVS Health. And Shawn Guertin, the Chief Financial Officer, is with us today.

QUESTION AND ANSWER SECTION

Analyst:A. J. Rice

Question – A. J. Rice: Let me just sort of kick it off with an open-ended question. If you think about this year, Shawn, we're on our 11th month. It's been a lot of things that have developed and transpired. But what would you sort of highlight is some of the wins for CVS and maybe some of the challenges?

Answer – Shawn M. Guertin: Yeah. I think from a big picture perspective, what I'd say, really, the year has been extremely successful, especially it pertains to 2022. And I'll talk a little bit more about it. But if there were a few clouds that popped up, they were more kind of for the future, mainly 2024, and I'll talk about that. But really I think, most importantly, for us, the core underlying performance of the business and, frankly, all three of our operating segments has really been exceptional, and it's been either at or better than our expectations for the year.

Our biggest business is the Pharmacy Services business, and that business has continued to grow at very strong rates, have a healthy margin profile. And this year, on the downside, it had some challenges with its 340B business that were sort of independent of the business itself. But really, the strength of the offering, the strength of our specialty pharmacy offering and the overall growth was able to sort of help that really achieve our objectives for the year. And that business has had an extraordinarily strong run the last few years, both from an operating income and a revenue growth standpoint. So the fact that that continued to move forward as it was a real positive.

Our HCB business, our insurance business, had a very strong year. Government programs continued to grow at a very, very good clip. I think, importantly, for that business, this was the first year that we were able to actually price for COVID in our products and the fact that we've largely gotten that correct in terms of the balance and the interplay between COVID and non-COVID utilization and factoring that into pricing. The MBR and the underwriting margins have been very good all year across all of our products, and I think that's a real positive.

One thing we don't talk about as much anymore, just because of how big government has been is the commercial membership has been growing consistently. This was our first year back into the individual exchanges, and that went according to expectations.

So, again, the underlying performance of this business has been strong. And this year, in particular, though, when

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you think about where we've been, the dramatic change in interest rates for this year has really impacted the investment portfolio that's behind this business, and we've had strain all year because of realized capital losses, but we've been able to more than overcome that and deliver on our numbers.

This is obviously the area where there's been the biggest development about the future. We're pretty disappointed, obviously, in the 2023 Star Ratings, which will impact the 2024 benefit year. And that's obviously something that's now going to take center stage. But I'd say we go into that with the core underlying fundamentals of this business being very, very strong in 2022.

And then, in retail, retail has continued to navigate its path to sort of meet or exceed its contribution. This is, with COVID, now priced into the insurance product. This is the segment where we actually see a fairly large incremental adder to performance through COVID, and that's turned out to be twice as big as we thought coming into the year. And we've been able to take advantage of that, both financially, but also to provide an important role to the community in terms of testing and in terms of vaccines. The headwinds and tailwinds in the retail business continue that you're all very familiar with, and we've continued to make progress during navigating those.

This is the first year, I think, where we've embarked on closing 900 stores over three years, and we're going to do about a third each year. That has gone very well, actually exceeded our expectations. We're retaining in excess of 70% of the scripts in nearby pharmacies. We've been able to redeploy over 95% of the labor force to other stores, which has really helped a great deal and in this environment. And so, that initiative is a multi-year initiative, but we're off to an excellent start.

So, all in all, it's really been – at an enterprise level, I should also say, there's been really a couple of things positive, our ability to both de-lever the balance sheet to create capacity to generate cash flow from operations has continued to exceed our own internal expectations. So as a company, that's an extremely important asset as we think about the future. That's gone exceptionally well.

And then, this last quarter, we reached agreement in principle, really, to settle the opioid litigation matters that exist. And again, providing certainty and providing a structure that, given the strength of our capital generation as a company, allows us to continue to go execute on our strategy, I think, is a tremendous positive for the future.

So really good operational baseline, have definitely cleared up some uncertainty about the future. We still really – the Stars challenge is probably the big challenge we have.

Question – A. J. Rice: Right. So on the most recent call, you talked about here's updated guidance for this year. These are some puts and takes that if you're trying to get a baseline to go into next year, you ought to take into account. And then, you said you could grow high-single digits, as you've talked about for a while, off of that baseline into 2023. When you look at that, what are the biggest swing factors in formulating that outlook for you for 2023, do you think?

Answer – Shawn M. Guertin: So when we look at 2023, just it's been our standard kind of MO not to include anything for prior year development. So you should always keep that in mind, and that would be plus or minus depending on how PYD does play out. So that's not in there now. Certainly something we're watching now is the flu. The early signs, obviously, are that it's running hotter than a normal season, and that is largely what we have baked in to that guidance is what we call a normal flu season. So higher levels of that will create strain in HCB. There was probably some offsetting pickup in the retail business, but the net of that is probably a little bit of – could be a little bit of strain.

We're watching the individual exchange membership closely. This is our second year back end, and we went from eight to 12 states. As you know, there's been some market exits. We expect to be the beneficiary in terms of picking up volumes. So I think it's likely we could end up with a little more volume than we think there. And we'll just have to assess the maturity of that business from a profitability standpoint when we look at it.

Our guidance assumes the PHE actually is going to end at the beginning of the year. If the PHE gets extended for another quarter, that is a favorable item to our outlook. And of course, things like wage inflation, we'll continue to watch carefully for the year in terms of what we need to do on that. But the toggle around those items is something that probably in the next three months, we'll have increased clarity on those points.

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Question – A. J. Rice: When you think about the flu. We haven't had a traditional flu season in quite a while. It is a topic of discussion in some of the presentations. Can you size what that typically looks like at least a normal year? I know this could be more, we'll see. And some of that's probably falling into the fourth quarter, some in the first. How does that split out typically?

Answer – Shawn M. Guertin: Yes. So for our HCB business, which is, basically, the old Aetna business, a normal flu season is about $400 million of expense for us. That is generally distributed in a typical year of 40% in Q4, and then 60% into the next Q1. And A. J. makes an important point that even a normal flu season would be higher than what we've had the last couple of years, right? So that's already sort of baked in there as a strain.

So if you were going to sort of toggle your thinking up and down for flu, you'd be working off of that $400 million number. Again, we'd probably get some mitigating benefit on the retail side and sort of the cough and cold categories in the front of the store and maybe with some of the flu agents in the back of the store. But the net-net is, in the past, higher flu has generally been a negative.

Question – A. J. Rice: You said you don't put prior period development in – or prior year development in your forward forecast. This year, I think it's running at about $0.12 contribution.

Answer – Shawn M. Guertin: Yeah.

Question – A. J. Rice: Is that a normal year? Is there any way to describe what a normal upside from PYD often is?

Answer – Shawn M. Guertin: Yeah. So that is not an atypical amount, and we haven't changed our reserving practices and we're comfortable with where our reserves are at the moment. So again, there's other factors at play, but the $0.12 we just experienced isn't in a typical amount of PYD.

Question – A. J. Rice: Okay. And then, the other thing I think, obviously, you don't have, but hopefully you will, is Signify.

Answer – Shawn M. Guertin: Correct.

Question – A. J. Rice: You're in a pending deal with Signify. I think the current thinking is that hopefully closes about midyear, I guess. And I know you've said that would be accretive day one. Would that be something that would be a positive for the back half of the year, potentially that's not in there now? And maybe that's a good opportunity to step back and make a few comments about why Signify was attractive to CVS?

Answer – Shawn M. Guertin: Yeah. So directly to the question, the answer is yes. It would be a positive. We expect it to be accretive when we announced the deal. We pointed people towards consensus estimates for them being a decent proxy. And so, if – when it closes in the middle of the year or thereabouts, we do expect it will be accretive and then get a full year of that for 2024.

I think there's two things, I think, building on how the question was asked, that are important. One is, Signify is a profitable asset. And in our guidance at Investor Day, we had talked about a contribution in 2024 of getting about 2% incremental growth from our strategy, and Signify takes us a long way there. It makes a big payment on delivering on that growth.

And so, to have that and know that that's going to run through for 2024, that's been a really positive and it certainly was one of the positive attributes. But more importantly, we've talked about the three areas that we're looking at from our strategy, which are kind of an advanced primary care, clinical care capability, provider enablement and care in the home, all with sort of a value-based wrapper generally around them.

And really Signify is not only a profitable asset, providing a very important service to the industry, it provides – it really checks two of those three boxes for us, right? It has a small, but growing kind of MSO capability around provider enablement called Caravan, which is very attractive and really focuses on health systems in terms of helping them on their journey with value-based care, but it also has this large network of clinical providers.

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And when you think about a lot of what you need to do in value-based care in the home, what you need is the network of providers, you need the logistics to get people there, and you need the identification of who might need sort of intervention of care in the home. And they have sort of all those sort of capability pieces that we can really build a platform from.

And this, to me, plays on two trends, one of which is value-based care, which I mentioned, but the trend of sort of increasing preference for the home as a place of treatment as well. So this really was, for us, I think, a winner on all fronts, in that it was accretive, it provides good returns on capital and it really advances us strategically.

Question – A. J. Rice: And the comment about getting the 2% to 3% contribution from inorganic growth, that goes back to your Investor Day comments and thinking about the long-term. I think you made that comment, and that was clearly a meaningful aspect of your M&A approach, but you also laid out, we're looking at primary care, we're looking at home, we're looking at provider enablement. And I think people tended to focus on the primary care and the areas you were looking at more so than the plug-in, the 2% to 3% growth. Does getting Signify done take pressure off of looking at those other things, particularly in light of the Star Ratings issue? Do you be more selective around anything else you all, give us your updated thoughts on additional M&A?

Answer – Shawn M. Guertin: Well, I think – I think we've proven to be selective and disciplined because you would do that under any capital deployment scenario. But the fact that you're really looking for specific capabilities to sort of launch and scale a strategy, it's really been important that we understand the capabilities, pressure test those and understand what we have. And I think that's led us to being selective.

But I think on the margin, making such a big down payment to our short-term deliverables, if you will, is definitely something that I think gives us a little bit more degrees of freedom. And frankly, as we sit here today, it always depends on the asset, but we'd be looking at something that wouldn't close now for a while. And its ability to contribute in 2024 might be more limited.

And we've always talked about the share repurchase capabilities that we have and the capital generation as a way to sort of be the safety net for that. And I think we still have that, but we still have a high degree of urgency around finding the right assets to sort of move the strategy forward. That is all about value, but it's also about capabilities, the ability of that to scale for a company of our size. And so, we're going to remain disciplined on that front. And when we find the right asset, obviously, we'll be committed to doing everything we can to get it. But it's got to be – I want to do – I don't want to do a deal; I want to do the right deal for the strategy.

Question – A. J. Rice: And actually just a cleanup question on the Signify. Once that's closed, is that going to – are you – you talked about at one point you might set up a separate health services division or something. Will that be the trigger or is that going to go in the benefits business or something?

Answer – Shawn M. Guertin: We'll work through that. I mean it's obviously – while it's a sizable enterprise in the scope of our company...

Question – A. J. Rice: Right.

Answer – Shawn M. Guertin: ... it's probably not a material element yet.

Question – A. J. Rice: Right. Okay.

Answer – Shawn M. Guertin: But as you just sort of think about that in concept through the long-term, I think it's the right sort of thinking.

Question – A. J. Rice: Maybe just give a little bit on the $2 billion gap, $1 billion of mitigation you see, and then the other $1 billion that you could potentially do through M&A or just likely a share repurchase. So walk us through a little bit of that.

Answer – Shawn M. Guertin: Yeah. So to set the table, the combination of the Star Ratings change and the loss of

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the Centene contract creates about a $2 billion unmitigated headwind for us in 2024. What we talked about on our – the framework we talked about on the earnings call assumes that we can mitigate about half of that. And that largely will come from our contract diversification efforts, as well as other things around operational efficiencies and clinical programs. But the contract diversification efforts really are going to be the gating item as to getting there.

And those are underway. And I would say, so far, so good, but there's still more work to do. There's still more approvals required on that journey. And so, that still needs to be worked through. I think we should know the answer to that, largely, by the time of our next earnings call. And so, we should have clarity around that. But – so as goes contract diversification, so goes I think that mitigation effort.

Assuming success there would leave about $1 billion that we would need to cover. And again, there's a lot of variables here at work in terms of share price and cost of debt and timing of all the things. But we think that we could offset that with up to $10 billion of sort of incremental share repurchase, which we have the capital capacity to do if that's what we need to do.

The real discussion here has to do with sort of long-term strategy and M&A and this deployment and sort of how to find the balance of those. And again, a lot of that until you have the actual asset in hand, and you can evaluate where you are from a financial position, where the asset is, what the terms of the structure of the deal are, it's hard to say could you do both? Could you only do one? There's certainly pathways to accomplish both on this, but we do have the capital capacity to do that. And in the absence of a strategic deal, we would intend to continue to deploy some of that capital – the share purchase to get to try to make up for that gap.

Question – A. J. Rice: And the strategic deal that would be meaningful enough and move the needle enough for you to say, hey, I'm going to go ahead and do that. Is that in those areas? What would have to be significant enough about it in, I mean it's primary care, the area is home health or whatever. What would you say?

Answer – Shawn M. Guertin: Yeah. I would – I mean, I would say it would most likely be something that had the primary care or the clinical care capacity to it.

Question – A. J. Rice: Okay.

Answer – Shawn M. Guertin: It could have other elements of home and things like that. But again, if you go back to those three boxes, we've at least checked in some way two of them. And I think that would be the third leg of the stool and thus has a lot of prioritization. Now, going forward, we could do other deals in those other areas as well. But when I really think about kind of the gating element and moving the strategy forward. It's really more in the clinical care primary care area.

Question – A. J. Rice: When we look and survey the primary care marketplace, there's PCP groups that are more focused on MA and shared risk arrangements, there's others that are focused on the commercial market and dealing with that, there's owning the clinics, there's the asset-light model. I mean, I could see CVS having interest in all of that. But do you have any orientation or preference as you survey the landscape.

Answer – Shawn M. Guertin: Yeah. I think, ultimately, the answer – you can almost think about these things as there's a couple of – there's a channel of this that's heavily MA-focused. And what I would say is, given the importance of MA, I think, to the industry and to the company, we will need an answer there.

Having said that though, I do think there's also a potential opportunity around commercial, the employer market, the retail side of healthcare. And the reason I divide them that way, I think, is because when you think about Medicare, it's the most mature form of a value-based model today. And what you have to do there is all about pulling those value-based levers.

Question – A. J. Rice: Right.

Answer – Shawn M. Guertin: When you begin to think about urgent care, commercial on-demand retail care, there's more of a volume element to that business, right?

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Question – A. J. Rice: Right.

Answer – Shawn M. Guertin: And so, sort of what you have to do there, at least as the models are constructed now, is a little bit different. So I do think we have a strategic pathway in both of those channels. I think the Medicare one is one we have to address given the importance of Medicare as a product offering, but I also see longer-term opportunity in that commercial employer retail health space as well.

Question – A. J. Rice: When I look at how the Star Ratings played out and have over the last few years, it does seem like the guys that have the physician shared risk arrangements benefit from that in their Star Ratings, especially on the qualitative side, which actually, in some ways, was your part of your issue with that survey.

Answer – Shawn M. Guertin: Correct.

Question – A. J. Rice: Do you think that is one of the answers long-term to the Star Ratings?

Answer – Shawn M. Guertin: Yeah. I can't say that the absence of that caused the Star Ratings problem because we've done so well for so long without it. Having said that, though, when you think about where we had – where the weak spot was as it was around those customer surveys. I think those survey results are better when you have this sort of fully integrated model, right? So it actually has made me more convinced that strategically doing something here makes sense along the lines of your thinking. But I definitely think it would add some positive value into that equation.

Question – A. J. Rice: Great. There are so many things going on in CVS, I could ask you questions for an hour, but we don't have them. What about the mitigation, so the $1 billion of mitigation. I guess when you initially announced that, I thought that was more you going out to the members and convincing them to change plans or something, but you're talking today and more recently about this regulatory approval, sort of maybe because we haven't seen someone have to deal with that in a while. Maybe walk us through what exactly you're doing to mitigate.

Answer – Shawn M. Guertin: Yeah. It really has more to do with the employer business, and the employer business – having the ability to write that employer business on a given contract. And some of the stuff that you talked about that has been done in the past was a little bit different, right, with individuals and innovating contracts and things like that. It's different than that. But at its heart, it's as simple as there's a great deal, I think, over half the members that are in the – the largest contract are employer-based members.

Question – A. J. Rice: Okay.

Answer – Shawn M. Guertin: And it's working both with the employers to sort of say, let's write on this contract. But to do that, there's some regulatory approvals we also need to just to sort of get some.

Question – A. J. Rice: All right. And you said the timing's pretty soon on that.

Answer – Shawn M. Guertin: It's active. Now, we're working on it now, and I anticipate that we should know the answer to that before the next earnings call.

Question – A. J. Rice: Okay. Interesting. All right. On the Centene RFP, do you want to spend a minute and just talk about that process? Any postmortem you've done on that? And then, when you talk about the cost that that is to CVS, is that a pretty definitive cost? Or is there a lot of potential variability on stranded cost, et cetera, as you come out of that?

Answer – Shawn M. Guertin: No, I think we have a pretty good handle on what the contract contribution was and where we have sort of the fixed expense challenges. And we've used that to sort of incorporate them into the $2 billion number. And I think what I'd say is it's a large $30 billion contract for us, plus heavily government-focused, obviously, health plan oriented. And in these jumbo contracts, it's – if you've seen it's cliche, but if you've seen one, you've seen one. And we think we've provided a ton of value. We think we put a lot of value on the table. But

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ultimately, companies make decisions to move based on some of their own internal needs. I think they've been pretty clear this was over economics. I think we made an extremely attractive economic offer to that.

So at the end of the day, I'm very disappointed to lose such a big contract. But I think by the same token, we've also continued to win health plan business. So I don't really see this as a read-through to our ability to succeed in the health plan space.

Question – A. J. Rice: Right. On the PSS business, you've talked about the selling season, the fact that you had about $3.5 billion in gross wins, you had a higher-than-average retention rate. You put all that into the mix, it's very hard to translate that into what revenues look like on a year-to-year basis. Do you...

Answer – Shawn M. Guertin: I think revenue growth will be down a little bit. Obviously, we had such a big new business here this year. I think revenue growth will slow a little bit more. I mean our op income guidance for Pharmacy Services next year, roughly, would be in the mid-single digits. And I would think we'd see revenue growth comparable with that. Again, the top line and the bottom line of this business have grown so much the last two or three years, a normal year looks more peculiar than it probably should, right, for this business.

Question – A. J. Rice: And the one aspect to that would be, I guess, the specialty pharma conversion of HUMIRA and so forth. And it sounds like you had a little bit of that baked into your preliminary guys, but not necessarily. I mean, how much variability is there around that in your mind thinking about 2023?

Answer – Shawn M. Guertin: Again, it's all about timing, and we're still making this assumption that the multiple agents aren't present in the market until the second half of 2023. If that changes, right, that could change some of the timing, but we're largely assuming that that particular catalyst isn't going to really be present until the second half of the year 2023.

Question – A. J. Rice: Okay. And when you think about the benefits business, we're in the midst of open enrollment for Medicare Advantage for – as you said, you're on the exchanges for your second year and you've expanded the markets. Any early read on what you're seeing there? And maybe just remind us what your enrollment assumptions, generally, about that?

Answer – Shawn M. Guertin: Yes. So for Medicare Advantage, we've probably done better than industry growth the last few years. The guidance we talked about on the call assumes something that's closer to industry growth for that. And we're still early and potentially tracking, I think consistent with that at this stage.

I think it's likely that we will do better. I mean, the discussion we had in the earnings call, we were going from eight states to 12 states. So incrementally, we expected some modest growth just from that. But with some of the big market exits, I would anticipate we're going to have more volume than we anticipated when all is said and done.

Question – A. J. Rice: And then, in M&A, at least going from this year to next, I think you did say this was a year where you thought you'd have some step up in margin, have I got that right?

Answer – Shawn M. Guertin: No. I mean our margins are pretty steady...

Question – A. J. Rice: Okay. Okay.

Answer – Shawn M. Guertin: ...in our target zone. So there shouldn't be a lot of movement.

Question – A. J. Rice: And when you think about the Star Ratings hit, I know historically, sometimes when people have had a Star Ratings hit, it takes a couple years to get back to their previous levels and begin to show growth. Are you thinking about a 2024 is sort of just a one-year, and we've got time to make investments to get back on track? Or do you think that carries over a year or two?

Answer – Shawn M. Guertin: I'll tell you, we're pushing the organization extremely hard for this to be a one-year thing, but it's an important point that you raised because it is a bit of a live fire exercise, in the sense that when you

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find out – when you get the news, you're in the middle of the next measurement period in many regards. And so, your degrees of freedom to sort of influence the outcome are a little bit more limited.

Question – A. J. Rice: Right.

Answer – Shawn M. Guertin: So we certainly see a pathway to execute on that. But I also understand why this can be a two-year phenomenon for people when you sort of look at the timing dynamics around this. So we've set a goal for our organization to have it be a one-year problem. And what I'd say makes me feel better about that is, if you dig into the numbers, we're not way, way off. We barely fell below a number of the measures.

And so, the increment we need is, I think, something that is achievable. But to your point, it's certainly not a slam dunk since you're in the middle of the next measurement period.

Question – A. J. Rice: And real quick, on the retail side. You've talked about the store closure decisions. You did a third of those this year. That's a drag initially, but then it becomes, hopefully, a positive contributor. How do we think about that?

Answer – Shawn M. Guertin: It's probably been closer to neutral. If it's a drag, it's modest this year. That begins to become more accretive in 2023, and then another step in accretion in 2024 when you sort of complete the cycle. And that's all about script conversion really is the driving force there.

Question – A. J. Rice: Okay. And the other thing on retail to get in under the wire was I think the front-of-store has had tremendous benefit from foot traffic with the COVID vaccine with the at-home testing. But even the underlying front-of-store has probably done a little better than we would have thought. Do you think this is the new normal, or are you still sort of, I mean...

Answer – Shawn M. Guertin: I guess I'm still being a little circumspect, but it's hard to keep saying it's not when it keeps happening. And I don't know this is probably five or six quarters in a row where we've started to see that underlying strength. And so, I'd like to think that some of the activities we've had around sort of digital conversion and things like that. And we're saying so. But I certainly think that there's going to be a bit of – if it's at today's level, remains to be seen, but I think there is going to be a sustainable level that carries through the next few quarters.

Okay, great. All right. With that, we'll wrap up. Thanks so much, Shawn. Thanks to CVS Health for participating in our conference. And next up in this room – let me make sure I have that – is Henry Schein.

Thank you, everyone.

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