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CVS Health Corp. (CVS)

Q2 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, everyone. My name is Bruno, and I'll be your conference operator for today. At this time, I would like to welcome everyone to the CVS Health Second Quarter 2023 Earnings Conference Call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks, there will be a question-and-answer session. [Operator Instructions]

I will now hand over to your host, Larry McGrath. You may begin your conference.

Laurence McGrath

Senior Vice President, Investor Relations & Business Development, CVS Health Corp.

Good morning and welcome to the CVS Health second quarter 2023 earnings call and webcast. I'm Larry McGrath, Senior Vice President of Business Development and Investor Relations for CVS Health. I'm joined this morning by: Karen Lynch, President and Chief Executive Officer; and Shawn Guertin, Executive Vice President and Chief Financial Officer.

Following our prepared remarks, we'll host a question-and-answer session that will include additional members of our leadership team. Our press release and slide presentation have been posted to our website, along with our Form 10-Q that we filed this morning with the SEC. Today's call is also being broadcast on our website, where it'll be archived for one year.

During this call, we'll make certain forward-looking statements. Our forward-looking statements are subject to significant risks and uncertainties that could cause actual results to differ materially from currently projected results. We strongly encourage you to review the reports we file with the SEC regarding these risks and uncertainties, in particular those that are described in the cautionary statements concerning forward-looking statements and risk factors in our most recent Annual Report filed on Form 10-K, our Quarterly Reports on Form 10-Q, the most recent of which was filed this morning, and our recent filings and Form 8-K, including this morning earnings press release.

During this call, we'll use non-GAAP measures when talking about the company's financial performance and financial condition. You can find a reconciliation of these non-GAAP measures in this morning's press release and in the reconciliation document posted to our Investor Relations portion of our website.

With that, I'd like to turn the call over to Karen. Karen?

Karen S. Lynch

President, Chief Executive Officer & Director, CVS Health Corp.

Thank you, Larry. Good morning, everyone, and thanks for joining our call today. CVS Health closed another successful quarter, delivering on our financial commitment through the power of our diversified business model and focused execution of our strategy. We have been relentless in the pursuit of our goal to deliver superior health experiences by improving outcomes, lowering costs, driving higher levels of engagement and broadening access to high-quality care.

So far in 2023, we have achieved several key accomplishments. First, we acquired Signify Health and Oak Street Health, two best-in-class value-based care assets. We are making progress integrating these multi-payor

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companies to create meaningful value. We are unlocking opportunities by connecting Signify and Oak Street to CVS Health assets, such as Aetna, MinuteClinic and CVS Pharmacy, and driving patient engagement and growth. As we scale our Health Care Delivery assets and realize synergy opportunities, we will accelerate our long-term growth trajectory.

Second, we expanded our individual exchange offering to 12 states and successfully onboarded more than 1 million new members. Strategically, this is an important marketplace that grew to approximately [ph] 15 million (03:43) enrollees in 2022. Our success with this population lays the foundation for future earnings growth at Aetna and creates connections for these members across all our integrated assets.

And finally, our ability to generate strong cash flows enables us to invest in our long-term strategy and return value to shareholders. Through June 30, we generated more than $13 billion of operating cash flow and returned more than $3.5 billion to our shareholders. We expect to continue to return cash to our shareholders and deploy capital to enhance shareholder value.

Today, we reported second quarter adjusted EPS of $2.21 and adjusted operating income of $4.5 billion. Our diversified business, strengthened by our exceptional execution, positions us to navigate emerging headwinds in Medicare Advantage and a changing consumer environment. We are reaffirming our full year 2023 adjusted EPS guidance range of $8.50 to $8.70. Shawn will provide more details on our updated outlook for the year shortly.

Turning to our performance highlights for the quarter. In our Health Care Benefits segment, we grew revenues to $26.7 billion, an increase of nearly 18% and delivered adjusted operating income of $1.5 billion. Medical membership in the second quarter was 25.6 million, an increase of 1.2 million members versus the prior year, reflecting broad-based growth including individual exchange, Medicare and commercial membership.

For our core commercial membership, this quarter marks the eighth consecutive quarter of membership gains. This growth reflects our differentiated product offering that address the total cost of care and the whole health of a member through our integrated solutions.

Medical cost trends were well-controlled in our Commercial and Medicaid books of business. Consistent with the broader industry, elevated medical costs emerged in our Medicare Advantage business, which became apparent in the latter part of the quarter. The primary driver of these elevated medical costs was greater than expected utilization in outpatient settings. Shawn will discuss these trends in more detail.

In Medicaid, the state of Oklahoma awarded us a new statewide Medicaid contract beginning in April 2024. That'll add approximately 200,000 members. This win demonstrates our market-leading ability to comprehensively support Medicaid populations through our deep local relationships, investment in clinical programs and integrated well-being solutions.

This quarter, we are able to offset the pressures in our Health Care Benefits segment with continued strong execution in our Health Services segment. Revenues grew to $46.2 billion, an increase of nearly 8%. Adjusted operating income grew 3.5% to $1.9 billion.

These results were driven by our Pharmacy Services business. We consistently demonstrate value to consumers and our clients by successfully managing drug cost trends and bringing innovative clinical solutions to the market.

In the second quarter, branded drug revenue increased, in part, driven by the GLP-1 category. This expensive and fast-growing category presents new choices for the over 70 million adults in the US who are living with

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obesity and the nearly 37 million people who have type 2 diabetes. We are well-positioned to deliver value to customers in this category with our weight loss program and utilization management tools that drive the lowest net cost for our clients.

Every day, we create competition, drive the lowest net cost, and deliver transparency, value and choice to our customers. This is the foundation of our continued success and our market-leading position.

Turning to Health Care Delivery, both Signify Health and Oak Street Health had strong quarters, delivering business performance consistent with our expectations. These assets bring core capabilities to our multi-payor value-based care platform that drive optimal patient engagement with health services across multiple channels. In the short time since we closed these transactions, we've launched efforts to drive high patient engagement by leveraging our CVS Health assets.

Signify Health is core to our home health services strategy. Signify enables better health in the home and has an unmatched ability to build trust and connect with 3 million patients in their home annually. We capture valuable insights into a patient's broader care needs during in-home evaluation and are able to create engagement points across other health services for our health plan partners.

These engagement points ultimately drive better care, lower the total cost of care, such as reducing hospital re-admissions and improving health outcomes. Survey results show that members who are highly satisfied with their Signify in-home evaluation are 26 times more likely to recommend their health plan and 74% more likely to consider additional health services. Signify's customers recognize the power of this trusted relationship and the value of these home services.

Since the close of the acquisition, Signify has demonstrated exceptional retention of its health plan and health system customers. We've added new relationships, expanding the opportunity to bring Signify's services to more Medicare members. CVS Health's trusted brand and our broad customer touchpoints further increase opportunity for Signify to engage with patients and expand the services they deliver.

This quarter, there was a strong demand for both in-home evaluations and additional Signify services in the home. We launched new member engagement initiatives at select CVS Pharmacies to drive IHE conversion of Aetna Medicare members and CVS Pharmacy customers to Signify. Early results are promising with higher engagement across the CVS Health channels utilized.

Turning to Oak Street Health, we are accelerating patient growth through our broad community presence and ability to engage consumers across multiple channels. Today, there are approximately 1 million Medicare eligible seniors who visit CVS Pharmacies each week that are located near an Oak Street clinic. We launched new member engagement initiatives focused on creating connections between Medicare eligible CVS customers, both in-store and digitally, and Oak Street Health providers. We are also connecting Aetna Medicare members who are currently without a primary care physician with their local Oak Street provider to reengage them in their care. These initiatives will drive Oak Street patient growth and accelerate the path to mature clinic profitability while broadly serving the needs of Medicare members.

As Oak Street expands to additional geographies, these opportunities to drive higher patient growth will continue to increase. By the end of 2023, we expect to have Oak Street clinics in 25 states, up from 21 at the close of the transaction. We will also open new Oak Street clinics co-located with CVS Pharmacies this year and have already identified additional locations for 2024. We now expect to build 50 to 60 clinics next year.

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Turning to our Pharmacy & Consumer Wellness segment, we grew revenues to $28.8 billion, an increase of nearly 8% versus the prior year. We generated $1.4 billion of adjusted operating income in the quarter, a decrease of 17% from the prior year, largely due to lower COVID-related volume.

Our Pharmacy business delivered another quarter of strong performance. Same-store Pharmacy sales increased by more than 14% versus the prior year, primarily driven by pharmacy drug mix and brand inflation. Same-store prescription growth, when excluding the impact of COVID, grew by nearly 5%. This growth is fueled by our efforts to provide a differentiated omni-channel pharmacy experience that meets customers where they are.

In our Front Store, we've grown market share, increased household penetration and delivered historically high service levels. This positions us well to manage through economic volatility. In the quarter, our same-store sales, excluding OTC test kits, grew by more than 1%, demonstrating the resiliency of our Front Store offerings in a more challenging consumer environment.

We also continue to make progress growing our digital members and sales. This quarter, we exceeded 53 million unique digital customers, up over 2 million from last quarter. Our digital sales increased 24% versus the prior year, including a meaningful increase of 65% in our over-the-counter health solution offering. This offering is highly valued by our health plans members allowing them to conveniently access their important OTC benefits.

Last quarter, we discussed optimizing our cost structure. This morning, we announced a restructuring charge of nearly $500 million associated with the elimination of approximately 5,000 non-customer-facing positions as well as the impairment of noncore assets. These efforts are expected to generate over $600 million of run rate savings beginning in 2024.

Our optimization efforts have also focused on identifying additional opportunities to drive efficiency and operational excellence using technology. For example, we've been selectively using artificial intelligence for some time and are increasingly finding opportunities to improve the efficiency of our operation, enhance our customer experience and increase our competitiveness.

When combining all of our productivity initiatives, we are confident we will achieve the $700 million to $800 million of cost savings that we are targeting in 2024. These actions enable us to reallocate resources and invest in critical growth areas, such as health services and technology, which are the biggest enablers of our strategy.

We've taken meaningful steps executing on our long-term strategy, with tangible proof of the value of our unique integrated offerings. We look forward to providing more details at our Investor Day on December 5 in Boston.

I'll now turn the call over to Shawn to provide a deeper look into our results and our guidance. Shawn?

Shawn M. Guertin

Chief Financial Officer & Executive Vice President, CVS Health Corp.

Thank you, Karen, and good morning, everyone. Our second quarter results continue to demonstrate the strength of our execution and the power of our diversified enterprise. We delivered strong revenue growth, adjusted earnings per share and cash flow from operations.

A few highlights regarding total company performance. Second quarter revenues of nearly $90 billion increased by more than 10% year-over-year, reflecting strong growth across each of our businesses. We delivered adjusted operating income of nearly $4.5 billion and adjusted EPS of $2.21, representing decreases of approximately 10% and 13% versus prior year, respectively.

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These decreases were primarily due to declines in our Health Care Benefits and Pharmacy & Consumer Wellness segments, partially offset by strong execution in our Pharmacy Services operations.

Our ability to generate cash remains outstanding, with year-to-date cash flow from operations of $13.3 billion. These cash flows were impacted by the timing of CMS payments that are expected to normalize in the fourth quarter. Excluding this impact, our cash flows from operations remains strong at $8 billion.

Shifting to the details for our Health Care Benefits Segment. We delivered strong revenue growth versus the prior year. Second quarter revenue of $26.7 billion increased by 17.6% year-over-year, reflecting growth across all product lines. Membership grew to 25.6 million, an increase of 121,000 members sequentially, reflecting increases in our individual exchange and Commercial businesses, partially offset by the impact of Medicaid redeterminations.

Adjusted operating income of $1.5 billion in the quarter declined approximately 20% versus the prior year. This decline was driven by a higher-than-expected medical benefit ratio, partially offset by higher net investment income and strong execution on operating cost management.

Our medical benefit ratio of 86.2% increased 350 basis points year-over-year, reflecting higher-than-expected Medicare Advantage utilization in the second quarter. These trends were primarily driven by higher utilization in the outpatient setting, as well as dental and behavioral health. We also recognized higher utilization levels in the first quarter in prior-year, resulting in lower year-over-year prior period development in the quarter. It is important to note that utilization in our other lines of business, including individual exchange, Commercial and Medicaid, remain generally in line with our pricing expectations.

Days' claims payable at the end of the quarter was 46.9, down 1.2 days sequentially. This decline was almost entirely driven by the impact of increased Medicaid pass-through payments in the quarter. Excluding this impact, DCP was stable, And overall, we remain confident in the adequacy of our reserves.

Our Health Services segment, which includes our Pharmacy Services business and our health care delivery operations, generated revenue of approximately $46.2 billion, an increase of 7.6% year-over-year. This increase was driven by pharmacy drug mix, growth in specialty pharmacy, brand inflation and the addition of Signify and Oak Street. These increases were partially offset by the impact of continued client price improvements.

Adjusted operating income of nearly $1.9 billion grew 3.5% year-over-year, primarily driven by strong execution and improved purchasing economics, partially offset by ongoing client price improvements and lower MinuteClinic COVID-19 testing. Total pharmacy claims processed in the quarter declined by approximately 1% versus the prior year and down 50 basis points when excluding COVID-19 vaccinations.

This decline was primarily attributable to the New York Medicaid carve-out largely offset by net new business. Total pharmacy membership was approximately 110 million members. Within our Health Services segment, we are very encouraged by the performance and growth of our Health Care Delivery assets. Signify completed 673,000 in-home evaluations in the quarter, an increase of 16% versus the same period last year and generated revenue growth of 19%.

Oak Street ended the quarter with 177 centers and 181,000 at-risk lives, increases over the same period last year of approximately 23% and 35%, respectively. Oak Street also significantly increased revenue in the quarter, growing 43% compared to the same quarter last year.

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Moving to our Pharmacy & Consumer Wellness segment. We generated revenue of $28.8 billion, up nearly 8% versus the prior year and nearly 11% on the same-store basis, reflecting the impact of pharmacy drug mix, increased prescriptions and brand inflation. These increases were partially offset by the impact of recent generic introductions, decreased COVID-19-related volume and continued reimbursement pressure.

Adjusted operating income of $1.4 billion declined approximately 17% versus the prior year, driven by reimbursement pressure, lower COVID-19 vaccines and testing and lower Front Store volumes. These decreases were partially offset by increased prescription volume and improved generic drug purchasing.

Same-store Pharmacy sales were up more than 14%, driven by drug mix, a 3.6% increase in same-store prescription volumes, and brand inflation. The increase in same-store prescription volumes, excluding the impact of COVID-19 vaccinations, were 4.9%. As Karen mentioned, our Front Store business is not immune to trends in the broader economy, but we have shown resiliency in the face of these challenges and continue to demonstrate the value we offer consumers. Same-store sales for the Front Store were down 30 basis points, primarily due to declines in cough/cold and flu and OTC test kits. Excluding the impact of OTC test kits, same-store Front Store sales were up by more than 1%.

Turning to the balance sheet. Our liquidity and capital position remain excellent. Our ability to generate cash flow has always been a strength of our organization and the enterprise continues to identify new opportunities to optimize our balance sheet. Through the second quarter, we generated cash flow from operations of $13.3 billion, bolstered by the CMS prepayment I discussed earlier, and ended the quarter with approximately $3.3 billion of cash at the parent and unrestricted subsidiaries.

During the quarter, we issued approximately $5 billion of long-term debt and repaid our outstanding $5 billion term loan that was used to fund a portion of the Oak Street transaction. Through our quarterly dividend, we returned $795 million to shareholders. We remain committed to maintaining our current investment grade ratings while preserving flexibility to deploy capital strategically.

A few other items worth highlighting for investors. We recognized acquisition-related transaction and integration costs associated with the Signify and Oak Street transactions, as well as additional office real estate optimization charges in the quarter for a total of $168 million. As Karen mentioned in her prepared remarks, we also took a restructuring charge of nearly $500 million associated with our cost optimization efforts and the impairment of noncore assets.

Turning now to our outlook for 2023. We are reaffirming our adjusted earnings per share guidance of $8.50 to $8.70. This guidance reflects our performance through the second quarter as well as a higher-than-expected Medicare Advantage medical cost trend for the remainder of 2023, offset by strength in our Pharmacy Services business within our Health Service Segment.

In the Health Care Benefits segment, we now expect our 2023 medical benefit ratio to fall at the high-end of our previous range of 84.7%, plus or minus 50 basis points, reflecting impact of higher Medicare Advantage utilization. While there is uncertainty surrounding the duration of this utilization spike, our 2023 guidance now prudently assumes that these medical cost trends will remain elevated for the rest of 2023. This update also results in a change to our guidance for adjusted operating income, which we now expect to fall in a range of $5.99 billion to $6.12 billion. While we are encouraged by trends in our individual exchange business, this guidance continues to reflect a prudent and cautious stance for that business.

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In our Health Services segment, our updated adjusted operating income guidance is a range of $7.11 billion to $7.23 billion, reflecting the strong execution year-to-date in our Pharmacy Services business and our expectation of continued strength for the remainder of the year. Developments in our 340B business continue to align with the guidance we provided on our first quarter call.

In our Pharmacy & Consumer Wellness segment, we now expect adjusted operating income in a range of $5.63 billion to $5.73 billion. This updated guidance reflects strong fundamental execution year-to-date, while recognizing the potential for a weakening consumer environment.

Shifting to our cash flow. We continue to anticipate strong full year 2023 cash flow from operations in a range of $12.5 billion to $13.5 billion. As a result of prioritization of our portfolio to optimize our cost structure, we now expect capital expenditures in a range of $2.6 billion to $2.8 billion. We continue to maintain our projections for interest expense and share count. And finally, we now project our adjusted effective tax rate at 25.3%. You can find additional details on the components of our updated 2023 guidance on our Investor Relations webpage.

Before concluding my prepared remarks, I would like to address our medium-term growth projections and targets. As Karen touched on in her remarks, CVS Health benefits from the diversity of our operations and this positions us well to be resilient in the face of adversity. We take our commitments seriously, as evidenced by the announcement this morning of our cost-cutting initiatives, which will meaningfully improve our positioning for 2024; however, given the emergence of multiple potential headwinds across our diverse set of assets, including uncertainty in Medicare Advantage, the potential for a weakening consumer environment and reduced retail contributions from COVID, combined with our plans to accelerate Oak Street clinic growth, our 2024 adjusted EPS target of $9 is no longer a reasonable starting point for our guidance range.

Given the more challenging outlook for 2024, and our desire to set guidance that is achievable with opportunities to outperform, we now believe investors should anchor their initial expectations for our 2024 adjusted EPS to $8.50 to $8.70, essentially flat to our existing 2023 guidance range. As is our convention, this guidance does not assume any prior-year reserve development.

Given the level of uncertainty for 2024, we also believe investors should no longer rely on our 2025 adjusted EPS target of $10. We will provide more clarity on our longer-term earnings growth outlook at our Investor Day in December.

While emerging headwinds have created uncertainty for our 2024 and 2025 outlook, make no mistake. We are more convinced than ever in our long-term strategy. The power of our integrated model and care delivery assets will change how consumers and patients engage with the health system and how they receive care. We believe this will benefit customers, patients, payers and ultimately our shareholders.

To conclude, our second quarter results continue to demonstrate the power of our diversified enterprise and the resiliency of our businesses. We continue to maintain our focus on growth and operational execution as we work to become the leading health solutions company for consumers.

With that, we will now open the call to your questions. Operator?

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QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from A.J. Rice from Credit Suisse. A.J., your line is now open. Please proceed.

A.J. Rice
Analyst, Credit Suisse Securities (USA) LLC

Q

Thanks. Hi, everybody. I know Karen teed it up and you mentioned it a couple times, Shawn, taking into account changing consumer backdrop and then the MA uncertainty. Just on that, it sounds like on the consumer changing you're signaling about the cough/cold and flu being somewhat soft, but I wouldn't necessarily think that's related to the economy. What – are you specifically seeing something that's impacting your business from a consumer at this point in the retail side or are you just anticipating that? And then on the MA, obviously you gave guidance on the benefits in the back half of the year MLR, but what is your thinking about how some of the things you're seeing might impact Oak Street? And can you comment on your 2024 bids and whether they incorporate some caution around utilization?

Karen S. Lynch
President, Chief Executive Officer & Director, CVS Health Corp.

A

A.J., a couple things on consumer. Then I'll ask Michelle to talk a little bit, but as we saw June kind of emerge, and kind of predicting sort of this economic volatility and a potential recession, we saw a little bit of pullback in consumer behavior in June, so we are reflecting that in kind of our forward-looking approach. So I can have Michelle talk a little bit about what we saw. And then, I'll turn it back to Shawn to talk about the numbers.

Michelle A. Peluso
Executive Vice President, Chief Customer Officer & Co-President, CVS Pharmacy and Consumer Wellness, CVS Health Corp.

A

Yeah, and just on Karen's point, we had another solid quarter. It was a market share gain quarter again for the Front Store. We saw stronger household penetration and historically high Net Promoter Scores. So I think out of an abundance of caution, we're just looking at slightly softening Consumer demand in the back part of the quarter, along with comping historically high cough/cold and flu.

I will say, though, of course, the strength is coming from the investments we're making in omni-channel and our merch mix and service and simplifying pricing and promotion. We're rightsizing our cost structure with our store footprint, our distribution footprint, improving inventory turns. And we're really excited and [ph] convictuous (31:55) about the work we're doing with Oak Street Health and Signify to introduce more seniors and more Medicare eligible customers to the great offerings Signify and Oak Street Health have in the community.

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

A

So, there's a lot there, A.J., in your question so let me try to cover the ground as thoroughly as I can and I will have both Dan and Mike actually talk about respectively what we saw in Aetna and HCB.

As I mentioned in the prepared remarks, our MBR was up 350 basis points year-over-year. It's really important to look at and recall that last quarter we said we expected Q2 MBR to be up year-over-year. One of the main drivers in that is we printed 82.7% last year in the second quarter so there's a lot to do here with the starting point.

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Having said that, and allowing for that, Q2 did end up coming in higher than we expected and the real driver here is Medicare Advantage. And it's also important to keep in mind that Medicare is more than 50% of our premium revenue now. As I stated, I want to be clear that Commercial, Medicaid and exchange all performed consistent or even slightly better than our expectations in the quarter, but as we closed the month of May in mid-June, it became apparent that the Medicare costs were higher than we had anticipated in Q1 and that pressure was continuing into the second quarter. And the real driver remains the outpatient categories that we and others have been discussing, so let me have Dan talk a little bit about what we saw in Aetna and I'll have – Mike will follow that up with what we saw in Oak Street. And I'll talk come back and talk a little bit about how we've prepared our guidance for 2023 and 2024 in light of this.

Daniel P. Finke
Executive Vice President & President, Health Care Benefits Segment, Aetna, CVS Health Corp.
A

Yeah, thanks, Shawn. So, I think it's important to note that our Commercial and Medicaid lines of business were largely in-line with expectations. And as reported more broadly in the industry, we did experience higher than anticipated outpatient utilization in Medicare. This is likely due to some of these services that have been postponed by our seniors not feeling comfortable accessing the health care system during the pandemic. You can think about this as outpatient orthopedic procedures, hips and knees, some cardiac procedures, a little bit of increase in dental, and we're still seeing some continued levels of elevated mental health use.

Again, specific to Medicare and outpatient services, our inpatient volumes remain lower than our normalized levels. And that's the same across all lines of business, so it's something we're closely watching.

Michael T. Pykosz
Chairman, Chief Executive Officer & Co-Founder, Oak Street Health, Inc.
A

From an Oak Street perspective, we've seen similar trends on medical costs with outpatient spend being up across our payer partners. Specifically, though, we've had a really strong start to the year on care model execution at Oak Street. And so, we've been able to largely offset the increased outpatient costs through a roughly 4% reduction year-over-year in admissions per thousand. So we're able to offset the increase in outpatient with continued strong performance keeping our patients out of the hospital and decreasing inpatients.

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

Great. Thanks. So turning back to 2023 first, as I mentioned, Medicare did come in probably about 220 basis points worse than expected for the quarter. Given the way costs have emerged, it's more instructive to look I think at the first half of the year, which is off 100, 110 basis points versus our guidance expectation.

As Dan mentioned, there are aspects of this that make – that some of this could be from a pent-up demand bubble involving discretionary and deferrable services, which, if true, would potentially run its course and lessen over time. And some preliminary July data does show some of that improvement; however, at this stage, in the absence of any compelling evidence to the contrary, we think it's appropriate to be cautious in our outlook and have assumed that the 100 basis points of pressure observed in the first half of 2023 persists through the second half of the year. The result of this is what I mentioned in my prepared remarks, that the HCB MBR would be up about 50 basis points at the high-end of our guidance range.

In terms of 2024, 2024 will come down to two things. Where does the 2023 year settle out, which serves as the baseline to go into 2024, and then what level of trend do we experience off that baseline? Our 2024 MA bid did contemplate a degree of higher utilization, but if trends persist at the levels we've experienced in the first half, as

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contemplated in our current guidance, we will have already consumed that higher utilization assumption. If a higher level of medical cost trend then persists again in 2024, or, said differently, if we don't see an abatement in medical cost trend, we would then be pressured on our bid assumptions.

In the absence of clear indicators that utilization is abating and out of an abundance of caution, our revised 2024 guidance assumes that we have an incremental headwind in 2024 over our revised 2023 guidance baseline. To the extent utilization does abate, and costs develop more favorably in 2023 than we project, that could serve as upside to our outlook for both 2023 and 2024.

A.J. Rice
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. Great. Thanks a lot.

Operator: Our next question comes from Lisa Gill from JPMorgan. Lisa, your line is now open. Please proceed.

Lisa C. Gill
Analyst, JPMorgan Securities LLC

Q

Great. Thanks very much and good morning. First, Shawn, I want to say thank you for revising 2024. I think that that's a very realistic expectation. And I like the words of potential upside. So with that said, let me move to my question, and that's really around GLP-1s. As I think about the different components of the business, I heard you and Dan both talk about the fact that Commercial was in line, but just given the strength of what you're seeing on your pharmacy side of your business, is there not any impact on the medical side of your business due to GLP-1s?

And then, secondly, as we think about both GLP-1s, biosimilars, the strength in the Rx services component of the business, can you maybe just walk through what some of those components are? Are we starting to see more rebating activity around GLP-1s? I know Karen had made a comment around programs around obesity and diabetes. If you can talk anything around that as to how we think about that going forward in the Pharmacy Services business. And then just lastly, on the Pharmacy Services business, any incremental comments on how to think about the 2024 selling season and how that went?

Karen S. Lynch
President, Chief Executive Officer & Director, CVS Health Corp.

A

Hi, Lisa. It's Karen and I'll start and hand it over to David Joyner and the rest of the team here, but as you mentioned, we have seen, consistent with the industry, higher levels of utilization in GLP-1 drugs across each of our businesses. And in HCB, what we saw was that we have seen increased utilization, but we feel like we have priced appropriately for it. And so, we feel that the risk is manageable in that business. As you look at the Pharmacy Services business, that is – we believe this is going to be a competitive category for us over time and, quite frankly, is the reason why, as you know, PBMs exist.

We have the opportunity to create competitiveness, provide lowest net cost, give additional programs like the programs I mentioned in my prepared remarks. And also, what we're seeing in the PCW business is it is generating very strong revenue there, but, as you know, with branded drugs, there is not a lot of margin with those kinds of drugs. So kind of overall, each of the businesses kind of have GLP-1 in them and they are impacting them in a variety of different ways, but I would just reemphasize the importance of the PBM and how we will continue to drive lowest net cost. And this is a perfect category to do that in.

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Let me turn it over to David to talk about what he's seeing on growth and in the Pharmacy Services business and the selling season, yeah.

J. David Joyner
Executive Vide President & President, Pharmacy Services, CVS Health Corp.

A

Sure. So, Lisa, this is David, and thanks for the question. As we look forward into 2024, we obviously have the headwinds of the partial termination of Centene, and obviously we're working close with the orderly transition of both the Medicare and Medicaid lines of business. So as a result of Centene, our health plan business will be down year-over-year as we continue to focus on pricing discipline for both prospective customers and renewing our in-force customers.

So as I look at 2024, net new business and the pipeline is definitely weighted more towards the employer business this year. And we've had a particularly strong year in the national employer accounts as we won close to 60% of the clients that have changed PBMs for 2024. We've seen this success with enterprise accounts as well, where we share common customers with Aetna. We continue to believe we offer the best PBM operating model in both cost of goods and service levels in the industry and are confident in our long-range growth outlook as we wrap-up the 2024 selling season and turn our focus towards growing in 2025 and beyond.

And finally, I would just suggest we continue to focus on leveraging our full suite of CVS Health assets, including the most recent value-based care acquisitions of both Signify and Oak Street, as we continue to offer a differentiated value prop in the multi-payor marketplace.

[indiscernible] (41:51)

Karen S. Lynch
President, Chief Executive Officer & Director, CVS Health Corp.

A

Talk about biosimilars and about another one of her questions.

Daniel P. Finke
Executive Vice President & President, Health Care Benefits Segment, Aetna, CVS Health Corp.

A

Sure. So it was a multi-faceted question, so let me just add on the biosimilars, because we obviously have not announced our position for the coming year, but that said, we've had a very thoughtful and planned approach to the Humira biosimilar launch and it's been planned for several years now. So as a result, our customers have already benefited from the competition with a much lower spend in the category.

So as you prepare for the formulary launch, we're committed to the same lowest net cost strategy that we employ across our formulary and will be using the additional competition to create even more value for our customers and members. So I'd like to offer two additional points.

The first is we have a unique track record in the biosimilar-like market. So as you recall several years ago, where we removed Lantus from our formulary and added a lower list price biosimilar-like product called BASAGLAR, we were able to convert 97% of the volume and delivered more than 21% savings to our customers. So while we haven't announced our formulary strategy yet, we took a similar approach in the hep-C category by announcing last and was also able to deliver the lowest net cost and the most innovative solution for our customers.

Not only will we continue to provide our clients and members optionality, we're also ensuring that we're providing the lowest net cost options and that our selective strategy helps our clients truly realize the savings. So bottom

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line, and this speaks to the broader biosimilar marketplace. We're committed to establishing a viable and durable biosimilar market and believe we're well-positioned to deliver innovation in the AI class. And we look forward to providing more clarity around Humira in the coming weeks.

Lisa C. Gill
Analyst, JPMorgan Securities LLC

Q

Great. Thank you so much.

Operator: Our next question comes from Michael Cherny from Bank of America. Michael, your line's now open. Please go ahead.

Michael Cherny
Analyst, BofA Securities, Inc.

Q

Good morning and thanks for all the details so far. Maybe if I can just dive in a little bit more on Medicare Advantage and the exchange business relative to the long-term outlook. Shawn, obviously not looking for anything beyond what you gave on the color, but the build includes clearly your work and your investments in Stars as you work your investments in the exchange business. Can you just give us a broad-based update on those two sides on where things are progressing and especially as we head into the fall, how you think about that push and pull dynamic relative to positioning for Stars for fiscal 2025?

Karen S. Lynch
President, Chief Executive Officer & Director, CVS Health Corp.

A

Yeah, Michael, let me start on Stars and Shawn can fill in the details on the numbers, but, as you know, we have made significant progress – efforts and have made significant investments in making progress in our Stars performance. We've been very focused on our remediation efforts. Our contract diversification strategy is well underway. And all of our internal indicators are positive and show progress, but having said that, having this by such a narrow margin last year, I think we all recognize that it all comes down to the CMS cut point, so we'll know better in October, but our internal measures are positive from how we measure it.

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

A

And, Michael, on exchanges, we're another quarter in and things are still looking positive. And as I mentioned, we've been – we continue to be cautious in our outlook in terms of what we're planning on that from this year, but both the revenue and the utilization side have been in line with our expectations. And so I think that that really is something to think about as an opportunity for the future.

We have 1 million member book now, probably something like $5 billion in revenue potentially this year. And it's not making a meaningful contribution. And one of the benefits of getting to scale so quickly is I think we can now turn towards at least getting some contribution of profitability from that business and that would be our plan for 2024 and beyond, that that would begin to be a profit contributor for us. So I do think it's one of the growth levers that we have.

Michael Cherny
Analyst, BofA Securities, Inc.

Q

Thanks so much.

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Operator: Our next question comes from Justin Lake from Wolfe Research. Justin, your line's now open. Please proceed.

Justin Lake
Analyst, Wolfe Research LLC

Q

Thanks. Good morning. A couple questions. So first, just on the MLR, Shawn, maybe you could give us a little more color in terms of, at least relative to our estimates and consensus, looked like you missed the quarter by 150, 175 basis points, yet you're raising guidance by 50. Might have been some intra-year development. I know the quarter had some prior-year in it as well, so just trying to kind of isolate what's going on there. If you can help us with some of that bridge, I'd appreciate it. And then on the guidance change, your – by my math, $500 million, $800 million of OI. Can you give us some increased clarity on where you're seeing that? For instance, how much of that is tied to MA assumption versus where you would typically be, et cetera? So if you could break that apart for us as well, that would be helpful. Thanks.

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

A

Yeah, there's a few pieces going on in the quarter that are worth calling out. I did mention one. Obviously, we had Medicaid pass-throughs. That sort of has pushed on the MBR a bit in the quarter. We actually did have unfavorable PYD this quarter, so we recognized that in the quarter. That's sort of pushing the number, but the biggest thing that's driving our guidance increase for the year is the change in outlook on our Medicare MBR. And that, like I said, for the quarter, is probably off a little more than 200 basis points. And I think it's more instructive, as I mentioned, to look at that for the first half and that's largely what we've assumed. So if you look at HCB going down about $400 million of adjusted operating income, obviously there's other moving parts under the surface, but most of that's the 50 basis points on the overall HCB MBR.

Again, the other lines of business are largely in line, if not even a little better than our expectations on HCB. Offsetting that, obviously, was our increase in the Health Services segment, driven by Pharmacy Services. That is about $500 million better. And again, that is driven by sound fundamental performance that Karen and David discussed. And you'll recall that we did talk about the underlying Pharmacy Services performance in Q1 was strong. And we've now carried that strong first half performance for the full year. And as was mentioned earlier in response to the question, we have decreased our outlook on PCW by about $100 million, considering the impacts we observed towards the end of the second quarter, softening consumer demand in particular we talked about, so those are the moving pieces. Inside overall AOI is pretty much flat to where we were, but those are the moving pieces under the covers.

Operator: Our next question comes from Kevin Caliendo from UBS. Kevin, your line's now open. Please go ahead.

Kevin Caliendo
Analyst, UBS Securities LLC

Q

Thanks. Shawn, I think you mentioned that you planned on opening more Oak Street clinics than originally planned, but I got a sense that was also an incremental headwind. Does that mean that you'll be using less off balance sheet or you had talked about potentially, if you increase, using off balance sheet metrics to do so. Is that still the case or has that changed?

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

A

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Yeah, so I do want to talk about that. You're correct in your assessment. Obviously, this is a very important and strategic investment in our future that we're making. And we continue to believe that there's high demand for more access to the differentiated Oak Street care model. Our analysis has consistently shown that accelerated clinic growth is the right thing to do in terms of optimizing the long-term returns on this investment and expanding access for at-risk populations. And, as Karen mentioned, we're going to do so in 2024 targeting 50 to 60 clinics. And Oak Street will and already is working closely with their payer partners in identifying the key geographies.

As you mentioned, our updated outlook for 2024 includes the full impact of this accelerated expansion without the benefit of any structured transaction. We are still evaluating the details and the merits of such a transaction, And we'll update you if anything definitive and material develops on that front.

Karen S. Lynch
President, Chief Executive Officer & Director, CVS Health Corp.
A

Hey, Kevin, I just want to make a couple comments on Oak Street. We've made significant progress already having closed, not that long ago, on driving patient growth and really leveraging the overall assets of the entire enterprise. We're using Signify to use the – recommend if people don't have a primary care to Oak Street. We're helping Aetna Medicare members that don't have a primary care and recommending them to Oak Street. We're using connections in our pharmacies as well. So I'm really encouraged by the opportunity and the growth and really excited about what we've seen and have more conviction now that the meaningful value that we thought we could unlock will surface over the course of the next couple years.

Kevin Caliendo
Analyst, UBS Securities LLC
Q

Great. Thank you.

Operator: Our next question is from Nathan Rich from Goldman Sachs. Nathan, your line is now open. Please go ahead.

Nathan Rich
Analyst, Goldman Sachs & Co. LLC
Q

Great. Good morning and thanks for the question. Shawn, could you – on the restructuring program, could you maybe talk about how much of the savings are in the 2023 guidance and do you see the full run rate for 2024? And then, on the new 2024 guidance, you mentioned a number of buckets that drove the guidance revision, the higher utilization, reduced outlook for retail given the macro environment. I think COVID and Oak Street were the other two. Could you maybe just help us think about the magnitude across each of those major buckets in terms of what drove the guidance revision?

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

Yeah, sure. So on the restructuring charge, there's the timing of all of this, it will have minimal impact the actions we take on 2023. To the extent there is any impact, we've thought that through in our reaffirmation of guidance, but really, this was a major step forward in delivering the $700 million to $800 million of G&A savings that we talked about in May. And the job elims [eliminations] alone, as we mentioned, contribute probably close to $600 million of that benefit, but there's other things we've done in terms of shutting down projects.

Obviously, there's been open positions we're not going to hire for as well. And so, we have a high degree of visibility into getting the effect that we committed to for 2024.

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On 2024 guidance, you're correct. There are really, I would say, three kind of performance items, some of which have a lot to do with the external environment and then obviously the one decision. The positive item, obviously, is we do expect some of the outperformance in Pharmacy Services that we're experiencing in 2023 will pull-through favorably into our 2024 performance.

I would note that not all this favorability will pull-through as it will naturally work its way into client pricing as contracts reset in 2024, so you can see the magnitude of our increase for this year. It's obviously not that much, because we're not going to pull all that through, but it's a meaningful positive item for next year.

Similarly, I think on the headwind side, the largest provision we've made in our guidance has to do with the Medicare Advantage performance. We've sort of sized the impact of that for this year and sort of have made provision for potential headwind on that. So I think you can kind of get in the neighborhood there. That would be the biggest other one.

And then the other one is in PCW, we've made some provision for the softening consumer demand to persist into next year, as well as potentially more decline in COVID for next year. We have factored that into our guidance. And as I was mentioning on the previous question, we've built in the full effect of the Oak Street acceleration as well. Obviously, that's a choice we're making and an investment in the future.

Karen S. Lynch
President, Chief Executive Officer & Director, CVS Health Corp.
A

And, Nathan, just to comment. I want to be very clear that we took a very thoughtful and careful approach to this restructuring. We were very deliberate in making sure that we had non-customer-facing roles and that we weren't taking any action that would risk the execution of our long-term strategy.

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

Yeah, and just one kind of housekeeping thing in that, again, as always, we've removed the PYD. That's close to $0.05 probably where we are on a year-to-date basis and so we've taken that out as well for 2024.

Operator: Our next question comes from Josh Raskin from Nephron Research. Josh, your line's now open. Please proceed.

Joshua Raskin
Analyst, Nephron Research LLC
Q

Great. Thanks for squeezing me in here and good morning. How are you thinking about the operating income contributions from Oak Street and Signify? I assume those are different directions in 2024. And specifically, in light of the risk change – risk model changes, I would assume there could be some benefit in Signify, some headwind for Oak Street. And if you could also maybe size the impact of the risk model changes on the MA segment in the Aetna business on reimbursement that would be helpful too.

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

Yeah, I can talk a little bit about the segment and then I can have Mike talk a little bit and Dan talk a little bit about the changes for 2024.

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It's an important question because as part of our strategy that we've talked about, the growth in the earnings from these two assets is an important part of sort of increasing our long-term earnings growth rate. And we do expect to have a meaningful contribution of earnings improvement from these two assets from their base in 2023 into 2024. And everything we've seen in our first quarter of ownership, I think has been consistent with that. And I think we're even more – have stronger conviction about sort of the value that we can bring. So they will be a positive contributor in our estimation of earnings growth in 2024. And I'll turn it to Mike and Dan to talk a little bit about sort of the risk model and the changes for 2024.

Daniel P. Finke
Executive Vice President & President, Health Care Benefits Segment, Aetna, CVS Health Corp.
A

Yeah, on the HCB side, I would think about it in this way. First of all, the model's being phased-in over time. We were pleased with that decision. Our modeling overall was very similar in the aggregate to the modeling of CMS. And, frankly, with our size of book, it allows us to really manage the impact over time, so minimal impact to HCB.

Michael T. Pykosz
Chairman, Chief Executive Officer & Co-Founder, Oak Street Health, Inc.
A

Yeah, from Oak's Street perspective, I think the thing to remember is a lot of the changes in the risk score model changes were driven by less specific codes being replaced by more specific codes, so you'll have less documentation codes with a lower coefficient on a high number of patients and higher coefficient codes on a lower number of patients. And so, the impact is going to be net of those changes, right, not the gross impact of that.

And one of the advantages of Oak Street is we have the same operating model and the same technology in all of our centers, so it allows it to react faster to those types of changes. And we are already implementing new protocols, new clinical guidelines, et cetera, to be aware of that.

And I'd really like to point out Oak Street has been very successful across programs with different risk adjusted methodologies. We were part of the Medicare Shared Savings Program, and we were a top 1% performer in that. We are the top performer in the ACO REACH program. And those have different risk-adjusted methodologies, CAHPS, et cetera, et cetera. And so I think it just goes to the fact if you're doing a great job taking care of people and keeping them out of the hospital and lower medical costs, that would be durable across any risk-adjusted methodology, so we're pretty confident in our ability to keep generating great results going forward.

Kyle Armbrester
Chief Executive Officer, Signify Health, Inc.
A

Yeah, just from a Signify standpoint, it's absolutely been a tailwind for us. Our clients and partners team up with us because we help manage this industry change for them. We stay ahead of the risk model changes. We help build new things into the Signify in-home business. We've seen a surge in demand for additional diagnostic and preventative testing work. It's an opportunity for us to expand into more follow-on care, so we're actually very excited about it. It's also been a nice touch point for us as we've integrated into the retail and pharmacy businesses at CVS. Managing medications inside the home is a huge unlock for us. And so we've been bringing in a deeper consumer engagement model with our partners inside the retail space and in pharmacy and we've seen really great results with the kick-off there with the Aetna membership.

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

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I would just quickly reemphasize one thing Mike said in his. The ability to have a common care model on a common technology platform and the ability to operationalize this should not be underestimated. And, in our view, that was a differentiating characteristic about their model, but that is a very important point that – in my opinion, that Mike made there.

Joshua Raskin

Analyst, Nephron Research LLC

Q

Makes sense. Thanks.

Operator: Our next question comes from Elizabeth Anderson from Evercore. Elizabeth, your line's now open. Please proceed. Elizabeth, your line's now open. Please proceed. You might want to check if your microphone is muted.

Karen S. Lynch

President, Chief Executive Officer & Director, CVS Health Corp.

Bruno, she might have dropped, so let me just wrap it up here by thanking our colleagues for their commitment and dedication that they show every single day, supporting our customers, our clients and our patients.

As we demonstrated today, we continue to execute on our bold goals and deliver outstanding performance, despite the challenging environment that we're in. And I really believe, and I know the team believes, that this is a testament to our consistently strong execution and our resilient business model and gives us the confidence that we can continue our momentum throughout 2023 and 2024.

Thanks for joining the call today.

Operator: Ladies and gentlemen, this concludes today's call. Thank you for joining. You may now disconnect your lines. Thank you.

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