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CVS Health Corp. (CVS)

Wolfe Research Healthcare Conference - Fireside Chat

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Justin Lake
Analyst, Wolfe Research LLC

MANAGEMENT DISCUSSION SECTION

[Abrupt Start]

Justin Lake
Analyst, Wolfe Research LLC

...CVS joining us for this fireside chat this morning. Obviously a lot going on. Tom Cowhey, the company's CFO has been kind enough to be here. I've got to mention Larry McGrath, the Head of Strategy and IR. Refused to sit up here with us, but he's doing God's work for the company. And we all appreciate it. Thank you, Larry.

So, Tom, before we delve into the numbers, a lot going on. You've had some management change. David steps in as the CEO, Prem steps up to the President. You've got four new board members that were announced yesterday. Maybe you could just give us kind of a lay of the land on how you see this changing the trajectory or kind of the strategy of CVS to the extent it is.

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

Absolutely. So first and foremost, so I don't get the hook from my legal team. We will make forward-looking statements today, so please consult our risk factors as filed in our documents with the SEC. Thank you.

And the – listen let me start with David. You know, I've known David since about 2008, and I was actually in the corporate development group of that and now we were evaluating alternatives for our PBM, and he ran the health plan business at Caremark and helped work us through that very successful outsourcing of our PBM to Caremark at the time. He is a great individual with a tremendous amount of an industry knowledge and experience. And so, we're excited to have him at the helm. I think he is going to bring a lot of great things to the organization.

And Prem is somebody that I've also got to know really well since I came back. And I don't think anyone realizes from the outside, Prem has run our pharmacy business, the retail business, as you think about it. But he is also

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our Chief Pharmacy Officer. So as you think about what does that mean, that means that things like our specialty operations are actually managed by Prem. And so when you think about, underwriting and pricing and the sales, for the specialty business that rolls up and P&L responsibility inside the health services segment inside Caremark. But Prem was actually managing those operations. And so a lot of this is very natural. Prem's been, in the PBM business for most of his career. He's been with CVS for about a decade now. And so I think there's a – there's something very natural about the two of them coming into this role. And, combined they were the driving force between cost vantage and true cost, which I think has really poised us to try to change the industry and change our pricing works in that industry.

With respect to the new board members, we're excited to work with them. You know, I think Glenview has been a fabulous shareholder. They've been very supportive. They're supportive of the strategy. I think, they have some views about how we can do things better and we're all ears. So, we're really excited to continue to work constructively with them. And I think that, this is going to be a good relationship.

QUESTION AND ANSWER SECTION

Justin Lake
Analyst, Wolfe Research LLC

Q

Appreciate that. Maybe to think about the current kind of baseline of what's going on both in the industry and at the company. Obviously, you saw our some higher costs in kind of running out of 2Q into 3Q and while you didn't give guidance, you gave a framework of how to think about costs into the fourth quarter? And you talked about an MLR, I think of 95.5% and you talked about the fact that, that would embed higher trend kind of peak trends coming out of 2Q that you had seen versus maybe what looked like some moderation in 3Q? So what I was hoping to get from you here is, you've closed October. Obviously, the key at least the key early data point is how 3Q is running out. You've got another month of insight into that, hoping you could share with us kind of what you're seeing there. Is it looking more like a return to that 2Q peak or is it looking, continuing running along what you thought 3Q was such that maybe things are a little better.

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

A

So October is obviously still pretty immature. What we had said when we were on the call, even, we said we had some early views onto what October looked like, which was part of what drove us towards this scenario. I'd say as we closed out the month isn't materially different than what I knew when we were partially closed on the month and when we talked at the earnings call. So we had seen net positive development of the 930 reserves. A lot of that was stemming from earlier dates of service with some pressure and from some of the more recent dates of service. And so that was what led us to present the scenario to investors. Some have called it a reasonable downside scenario. I think that's a good way to look at it. But, as you think about what we've experienced throughout this entire year, it has been, even as you look at the second quarter, the second quarter, was – we saw negative development off the second quarter. The second quarter trends were some of the highest that we've seen all year, particularly in our Medicare business.

And so I think we have a prudently cautious posture as it relates to how 2024 plays out that we've tried to outline for investors. But recognizing that – it's some of this variability that has caused us not to specifically guide for the remainder of the year or for 2025, right.

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Justin Lake
Analyst, Wolfe Research LLC

Q

And I get that October is going to be immature at this point, but I was more thinking about like how did – you're getting more information on July in August and September, right. That's going to tell you how 3Q really looked versus 2Q?

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

A

Right.

Justin Lake
Analyst, Wolfe Research LLC

Q

How is that – how is that coming out?

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

A

The formal October close is no different is not materially different than what I told – I shared with you at the time of the earnings call, right. So.

Justin Lake
Analyst, Wolfe Research LLC

Q

Got it. So it still feels like the end of the 3Q looks better than 2Q, but too early to call, is the way to think about it?

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

A

That's accurate. Yeah.

Justin Lake
Analyst, Wolfe Research LLC

Q

Got it. And so as you think about setting up 2025, I'm not – I know I'm not lucky enough to get guidance today, but maybe you can think about a framework that we should think about in terms of you, basically, in my mind, you gave almost all of the moving parts with the key swing factor being Aetna right, because the business is breakeven this year. You're effectively saying we believe strongly, it's going to improve next year. It's a question of how much improvement. So maybe you can give us, and honestly, if I think about, people thinking between, let's say $5.75 and $6.25, $5.56, it comes down to a $1 billion at Aetna give or take. And, $0.5 billion to a $1 billion at Aetna. And that's almost 0.5% to 1% margin. Right. How do you think about, what are the key swing factors that are going to decide whether you are, where that – where that shakes out?

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

A

Sure. So the easiest place to start is with the businesses that aren't losing money or that are losing money, right. And so, and I talked about this on the earnings call. So, a couple of points, potential loss on a $20 billion Medicaid business, right. That's really about the dislocation between acuity and trends.

These redeterminations have happened. Healthier individuals have come out of the pool, and the rates haven't caught up. That will start to get better early parts of next year, a little less than half the book renews on 01/01. So

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that's different rates. And I don't think you'll hit closer. You won't get to the right run rate until we're really at the end of 2025 into 2026.

So that's a, that's probably the smallest hole right now. But, it will improve. I don't think that it's going to get – it's not going to get back to target margins in 2025.

Individual. So individual exchange. Individual exchange is about a $10 billion net revenue book right now. And in the scenario I outlined, which incorporated a little bit of additional potential pressure on risk adjustment, you could see a case where that business loses, just use round numbers, up to a $1 billion this year.

So assuming that we're not carrying additional risk on risk adjustment into 2025, which we did this year, you have about a $225 million out of period from 2023 in those numbers. That should hopefully get better. And so then the question becomes, with this book that we've said, could shrink 20%, 25%, I wouldn't be upset if it shrank even a little bit more than that. We're losing $750 million to $800 million. We've put double-digit rate increases in, shrinking the book should help. Do I think it's going to get back to zero margin next year? No, but I think it will be a – we will make earnings progression in that business. And a lot of this is very geographically focused. So we have a lot of teams that are working on the ground to look at our networks and, what can we do with providers and, are the things that we can renegotiate. But that also makes it much easier from a decision-making standpoint if we're not seeing the progress in membership mix or in profitability or, journey towards that profitable target in 2025. We have the option to remove products or pull out of markets for 2026, which would – which should help that business over the course of the next two years.

And so then really it comes down to Medicare. So Medicare is a business that, if you say mid-single digits could lose, $3.5 billion this year. What's going to get better next year? So we have stars. Stars is $800 million plus or minus next year. That will definitely improve the picture. We've got about 0.5 million members that are looking for new homes this year. So they have – they're in existing Aetna product in 2024 and we've pulled those products from the market. About little less than 10% of that are in geographies where there's not a new Aetna product that was offered to them.

In the other geographies, they do have a choice to take a new Aetna product that's been redesigned. It's not a target margin product, just given the dynamics of this marketplace and, crafting an attractive product. But it's substantially better than the existing profile of these members and for that 0.5 million members, they are at MBRs that are materially worse than the average of the book. And so that's another margin improvement opportunity as we think about next year. And then the last piece is effectively, what we've done with supplemental benefits. And so what we've done with Supplemental Benefits is we've put in some hard caps and so things that have been pressure points this year. It's not mathematically possible for them to be the same amount of pressure in 2025.

And so that should improve results. The wild card is trend. So where is that trend at the end of the year? What does that mean for the jump off? And with the changing membership mix, how does that impact how we think about trend for 2025 and therefore how we guide? And that's something that we'll have a much better viewpoint on as we think about – as we get into February, because we'll have a much better sense as to how open enrollment has actually come to pass.

Justin Lake
Analyst, Wolfe Research LLC

Q

Got it. And if I just kind of wrap this up, the way I've been thinking about it is simply if you go back to 2Q, Company said we're seeing costs at X and we are – we've embedded trend – a trend assumption that's, continues to be pressured right. So Humana, United, typical trend in Medicare Advantage call it 4% to 5%.

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Everybody is saying they're bidding to normal next year, right. They're bidding for whatever the level is in 2024 to go up 4% to 5% next year. You were saying no. Given what we're seeing and, focus on margin over membership, we're going to be higher than that. We're going to be high-single digits, let's call it 6%, 7%, right. So a couple hundred basis points above where everybody else is pricing. And you could see it in the benefit designs, right, that we've all kind of looked at, right.

The – so now I think the question becomes, let's say you're at a $1 of costs in 2024, right as of the second quarter. If costs end up being a $1.02 right, they just end up being higher as you run out the year your run rate is a $1.02, do you still feel like you need to put that 6% to 7% trend so effectively grow off the even higher base at a higher level? Or do you assume, okay, this feels like peak, we can grow at 4% to 5%. And the way I've kind of framed it for investors in my note yesterday that I put out I guess yeah, yesterday, was you guide to $6 if you assume, even if the worst case happens the conservative case plays out this year, you assume trend then is more normal off that higher level and you guide to $5.50 if you just say, you know what, we're going to be super conservative no matter how high it got in 2024, we're going to assume 6% to 7%, right. And we're going to start there. Is that a reasonable way to think about that framework? When you put it all together?

Thomas F. Cowhey
Executive Vice President & Chief Financial Officer, CVS Health Corp.
A

There's – we obviously haven't guided for 2025, so I want to be careful not to do that here. But I think you're thinking about the – conceptually you're thinking about this in the right way, which is part of the reason that we haven't guided on 2025 yet as we want to see where 2024 is. We also want to see that membership mix and those two things are important for the following reasons.

The first is part of this is a function of – part of why we're different and not all of it, but part of why we're different this year is the level of supplemental benefit usage that we've had. We've talked about this, that some of the things that we did and products that were very popular, including with our OTC, our flex cards, our dental benefits, things that have been fundamentally restructured. And so part of the pressure that we've seen this year has come in those benefits that have been fundamentally rewritten.

And so if we see incremental pressure in the fourth quarter on a benefit, that benefit to use your example goes from a $1 to a $1.10 right then. But it's said it's capped for next year at $0.50 then...

Like that $0.10 of incremental trend pressure is not going to repeat. And so...

Justin Lake
Analyst, Wolfe Research LLC
Q

It's irrelevant to how you think about that, right?

Thomas F. Cowhey
Executive Vice President & Chief Financial Officer, CVS Health Corp.
A

Right, because it's a newly designed capped benefit. And so that's part of what we're trying to understand as we look and what we will be trying to understand as we look at where the fourth quarter plays out, as we think about that baseline, exactly where the trend happened is going to be really important, and exactly what membership we keep, what membership – in what products, in what geographies is really going to be important as we think about that mix and what that trend baseline going into next year will be.

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Justin Lake
Analyst, Wolfe Research LLC

Q

That's helpful. You mentioned the mix of membership. You mentioned the market exits. We're getting through open enrollment here, right, a little more than halfway through, it feels like. So where are we? Where are – what are you seeing in open enrollment versus what you would have expected? And how does it affect your view of next year?

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

A

So we talked about on the call that we think the aggregate book would be down about 5% to 10%. So the book is about 4.5 million members, plus or minus about a 1.4 million of those are group members, which will be pretty stable.

So that's a higher percentage decline on the individual and the D-SNP members inside the Medicare book. And I'd say where we are right now based on our early reads will be within that range. We'd probably start out somewhere in the middle. We may push a little bit up into that range over the course of the year, but I still think that's a pretty good range. And consistent with what we talked about. The mix of what we're seeing might be slightly different than we originally anticipated. We're seeing a little bit of pressure on our D-SNP sales and we're seeing a little bit better retention assumption on some of those new plans. I think we were more conservative in our resale assumptions than some of my peers, and so we're seeing a little bit more pull through on some of those resells. You know, net-net, we feel pretty good about where we are and how our strategies are playing out in the marketplace.

Justin Lake
Analyst, Wolfe Research LLC

Q

Got it. And one thing I wanted to touch on was the – one of the most surprising things I've heard from you is the fact that it doesn't sound like the new members are running at MLRs that are significantly higher, right than the existing book you had, right. So, I think everyone assumes right that there's some bolus of membership that's just rolling across the industry looking for the best set of benefits in a given year. And they're going to walk away from you this year potentially and go to someone else and end up being a problem.

It doesn't sound like that, at least from a new membership perspective, is significantly different than what you would have expected relative to exit – to new membership relative to existing. Can you expound on that a little bit for us? Tell us what you're seeing there?

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

A

Yeah. So we – one of the ways that we historically look at this is we take a look at what our – what's our most complete period in terms of claims, which as of the third quarter would have been year-to-date June, effectively. And as we look at that, we look at the new members and those new member cohorts. We look at their MBRs versus what our existing book is and we look at what the differentials are. And I'd say relative to history, it's actually in line, which suggests this is a mostly an all boats rising issue. And I would say a lot of the new members that we attracted this year are sicker. We did see a lot of growth in D-SNP, but they also, as we talked about earlier in the year, a lot of them were switchers rather than new to Medicare. So they came with existing revenue that helped to offset that and keep the MLRs in line.

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So that's where as we've evaluated this, this is why we – we've talked a lot about how we think that the, there's a couple of things going on inside the operations. Number 1, we priced aggressively. We priced through stars. We grew that growth, I think, came with individuals that were interested in specifically using those supplemental benefits, which they have. I think that level of growth and also the dynamic, the level of inpatient growth that we've seen this year, just in pure case claims combined with the pressure from two-midnight, which has helped – which has put a lot of stress on our operations. And so as you think about Aetna-specific issues, I think there's the supplemental benefit attraction there's and then there's the volume that pressured some of the operations because it takes probably 3 months to 5 months to get a case nurse up to speed. And we weren't appropriately staffed for all that volume at the beginning part of the year.

And so I think we're in a much better place now. I think we are well-positioned as we think about what expected membership levels will be next year. So I feel much better about how those operations are currently functioning and where they were in the earlier parts of the year.

Justin Lake
Analyst, Wolfe Research LLC
Q

Got it. And when you talk about operations, it brings me to a question I've gotten occasionally, which is, you've guided the 5% to 10% membership declines. You've talked about a big cost-cutting program to kind of offset some of that – the SG&A impact of that. Is there a number in terms of membership declines that you get uncomfortable with from a – from an M&A perspective, i.e., like it's going to be tougher to offset the SG&A impact there?

Thomas F. Cowhey
Executive Vice President & Chief Financial Officer, CVS Health Corp.
A

No, I think the teams are well-prepared for our expected levels of membership. And our current estimates are that, we will be well within the range that we planned for. And so I guess, if we were to decline dramatically, there would be fixed costs that we would need to go figure out how to get out. But we would go do that. We would do it aggressively. So I feel good about how we're positioned from that perspective.

Justin Lake
Analyst, Wolfe Research LLC
Q

And just to be clear, what visibility do you have, right? The – in terms of, I think you have a pretty good visibility on your new sales. But I know CMS is always putting out with a lag, right. The members that have gone – left you and gone somewhere else, right. How does – what do you know at this point? What do you – what percentage of your levers do you think you got to have visibility into now?

Thomas F. Cowhey
Executive Vice President & Chief Financial Officer, CVS Health Corp.
A

The teams are using a variety of different models by geography to determine that. I don't have the specific answer to your question, Justin, but we've spent a lot of time refining our estimates and our forecasting on membership over the course of the last 12 months. Given where we landed in 2024, I feel good about the new processes that we've got in place. And, I feel good about the guidance that we've given.

Justin Lake
Analyst, Wolfe Research LLC
Q

Got it. Got it. Before I move away from the Aetna business, I'll just ask you, you're one of the few companies that has talked about commercial risk trend as seeing some acceleration. Can you tell us what you saw in 2Q and

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what you've seen there and kind of how you're thinking about that from a pricing and a cost perspective into 2025?

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

A

Yeah, the part of the reason for those comments was that what we saw from this first quarter to the second quarter was that trends accelerated in order of magnitude 200 basis points to 300 basis points and so that's pretty steep. And so we have been for probably the last six quarters to eight quarters pushing price.

And so as we look at what we are expecting for next year, we're going to shrink that commercial risk block by a couple of hundred thousand members. Maybe a few hundred thousand members. And that's a function of our not wanting to get behind on pricing. But there are – while the pricing cycles are quicker in commercial, there are pricing cycles. And so the 11s are out right now, that are done, the 71s are predominantly done. And so as we see or if we see incremental trend pressure, the rates are for the most part locked for next year. And so we wanted to highlight for folks, if we were to continue to see pressure on that book, it will – it could not only pressure our ability to grow earnings, it could actually shrink margins in that business next year. And so we, in the interest of not surprising anyone we wanted to make sure that we were transparent about what we were seeing. October trends in commercial seem to be holding the third quarter was a little bit better than the second but I'd like to see more improvement there before I got more comfortable about what the outlook on that business might be.

Justin Lake
Analyst, Wolfe Research LLC

Q

And are you seeing your peers also push price out there? Or do you feel like they're pricing in a more normal trend?

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

A

We're starting to see the, a lot of this is really the blues, right? I mean, as you think about who is your competitor in group commercial, it is the blues. They have different profit profiles than we do. So we've started to hear anecdotally that they are also seeing pressure. But we have, part of the reason that we're expecting to shrink is because we're out in front of them in the marketplace. Partially offsetting that, we do have a lot of commercial ASC growth next year. We have a big contract that's coming in North Carolina, but we've also got a lot of startup costs associated with that.

And so, again, I feel good about where that business is going to be over the course of the next couple of years. But we're watching it closely as we think about 2025.

Justin Lake
Analyst, Wolfe Research LLC

Q

Got it. So there's a lot of focus on your cost vantage program at the – on the pharmacy side. The – I think the latest update was that you're set on pricing across most of your book except for the two big guys, right. That are out there the two big PBMs. Or the big three that – the two of the three that you don't own.

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

A

We've got one of them.

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Justin Lake
Analyst, Wolfe Research LLC

Q

Yeah. You got one early. I bet. So...

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

A

We've got early. Dave and Prem would like to argue on this stuff.

Justin Lake
Analyst, Wolfe Research LLC

Q

Tell me what your here – like how when should we hear more on this and kind of where do you feel like the tone of those negotiations are going? My impression has always been that, if you do get a deal with these big guys, it's probably going to be more economic, structure changes in 2025 rather than economic changes, right because their businesses are all kind of locked up on multiyear contracts. So they don't want to give too much back. But as you look out to 2026, 2027, that's where you might see some of the economic kind of stabilization that you're looking for.

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

A

I think that's consistent with how we characterize 2025 as being a transition year. So first, I would highlight that one of those major contracts went until some of the last weeks in December of last year. So this is not atypical that you're contracting with the – between the PBM and, CVS pharmacy would go late into the year. So I wouldn't read it into the fact that we don't have a signed contract on some of these is anything other than ordinary course.

And I would characterize the conversations as constructive and I think that we have good alignment. But we'll – we obviously need to get over the finish line with both of them. The – I think it's – I think that part of what we are really focused on for 2025, which is consistent with your comment, is we want to transition to this new model. We talked about this a lot at Investor Day. So our government business has got different pricing models. But for the commercial business, we have gotten to the point where we are 90-plus percent generic dispense rates because of the way that the incentives have been built into the pricing model, which has led us to a place over the course of a decade where we make most of our money in the pharmacy on a subset of generic prescriptions. So we're losing money on some of the generics we fill, and we're losing money on pretty much every branded prescription that we fill.

And so part of the advantage of cost vantage, is that we will level the playing field because this will be about acquisition cost plus a small markup, plus administration fee or dispensing fee. And so that model makes us indifferent to the type of script that we fill at the CVS store. So I think that in and of itself, that transition of that model is a real positive for the underlying fundamentals of that business. And if that comes with some erosion and, in excess of our cost of goods, I think that's okay as we move and get people used to this model. We've had good traction on the other side with David Joyner on the Caremark side, where we have about 70% of our clients that have implemented at least one of the elements of true cost, so that you'd start to see that end-to-end transparency between what it is that we're charging the PBM and what the PBM is asking us to adjudicate for the client at the point of sale. And so that's a real positive. And then I think we've started then to expose what the acquisition costs are. We will think about how we transition that model going into 2026 with our commercial clients and whether or not we can arrest that rate of erosion.

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Justin Lake
Analyst, Wolfe Research LLC

Q

Got it. Maybe flipping over to the HSS business, your guidance there for 2025 or at least your – where you kind of talk to people to in terms of earnings growth is more in kind of the mid-single digit range, in the mid to high single digit range. So, my bridge is 5% rather than, 6%, 7%, 8%. You talked about some conservatism there. You also talked about the fact that the first quarter started off a little bit different than you expected this year. And that's what – that's part of the reason for your conservatism. So maybe start off there. What was – what happened in the first quarter of 2024 that left you uncertain on a trajectory of that business? What got better as you went through the year and how were you thinking about 2025 there?

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

A

Or – so, part of what was different in 224 was really we had – we lost one major client and that client, when you're pulling out that number of scripts, the rebalancing of all of our client guarantees across the multiple networks that we manage was – it got off to a little bit of a slow start and we talked about this in the first quarter. The – those teams have, we're committed to hitting to – hitting their numbers. And they have really, I think, done an exceptional job of executing over the remainder of this year. And we have also seen strong specialty growth, but I would just say, we had a little bit of a rocky start this year, from a guidance perspective, if nothing else, we pulled that down a little bit. We gave a little bit back in the second quarter. And I think it's prudent to not get ahead of ourselves as we think about 2025. I'd say fundamentally, I feel good about where that business is and is going. And we've had some strong client wins. And we also have inside that segment the healthcare delivery business. I think there are multiple elements of that that should improve as we think about 2025, particularly, some of the pressures that we're seeing in Oak Street, whether that's from plan bids potentially getting better, but we also have another year of v28 implementation. But, I think that net-net, I think we want to make sure that we don't whipsaw investors and that we give them numbers, that we have a reasonable opportunity for upside.

Justin Lake
Analyst, Wolfe Research LLC

All right. I think we'll close there. Tom, I really appreciate you being here. I'll be back in a couple of hours with you HS. And thanks, everybody. Appreciate it.

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

Thank you all.

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