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EDITED TRANSCRIPT

HUM.N - Q4 2022 Humana Inc Earnings Call

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OVERVIEW:

Co. reported FY22 adjusted EPS of $25.24 and 4Q22 adjusted EPS of $1.62. Expects 2023 adjusted EPS to be at least $28.

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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Humana Fourth Quarter Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded.

I'd now like to hand over to your speaker today, Lisa Stoner, VP of Investor Relations. Please go ahead.

Lisa M. Stoner - *Humana Inc. - VP of IR*

Thank you, and good morning. In a moment, Bruce Broussard, Humana's President and Chief Executive Officer and Susan Diamond; Chief Financial Officer will discuss our fourth quarter 2022 results and our initial financial outlook for 2023. Following these prepared remarks, we will open up the lines for a question-and-answer session with industry analysts. Joe Ventura, our Chief Legal Officer, will also be joining Bruce and Susan for the Q&A session. We encourage the investing public and media to listen to both management prepared remarks and the related Q&A with analysts.

This call is being recorded for replay purposes. That replay will be available on the Investor Relations page of Humana's website, humana.com, later today.

Before we begin our discussion, I need to advise call participants of our cautionary statement. Certain of the matters discussed in this conference call are forward-looking and involve a number of risks and uncertainties, actual results could differ materially. Investors are advised to read the detailed risk factors discussed in our latest Form 10-K, our other filings with the Securities and Exchange Commission and our fourth quarter 2022

earnings press release as they relate to forward-looking statements, along with other risks discussed in our SEC filings. We undertake no obligation to publicly address or update any forward-looking statements and future filings or communications regarding our business or result.

Today's press release, our historical financial news releases and our filings with SEC are all also available on our Investor Relations site. All participants should note that today's discussion includes financial measures that are not in accordance with generally accepted accounting principles or GAAP. Management's explanation for the use of these non-GAAP measures and reconciliations of GAAP to non-GAAP financial measures are included in today's press release.

Finally, any references to earnings per share or EPS made during this conference call refer to diluted earnings per common share. With that, I'll turn the call over to Bruce Broussard.

Bruce Dale Broussard - *Humana Inc. - President, CEO & Director*

Thank you, Lisa, and good morning, everyone. We appreciate you joining us. Today, Humana continued the momentum seen throughout 2022 and reported another quarter of strong operating and financial results. Adjusted earnings per share for the full year are $25.24 which was above our previous estimate of approximately $25 and represents an annual growth of 22%.

We achieved this compelling earnings growth while also making meaningful progress in advancing our strategy, which I will touch on in more -- in a moment. Looking forward we provided full year adjusted EPS guidance for 2022 of at least $28 representing growth of 11% over 2022, consistent with our previous commentary. We anticipate this strong growth despite the headwind we faced from the divestiture of 60% interest in Kindred Hospice.

We also reaffirmed our expectations for a full year individual Medicare Advantage membership growth of at least 625,000 members, a 13.7% increase year-over-year. Recall that our 2025 adjusted EPS target of $37 is underpinned by an assumption of return to individual MA membership growth at or above the industry rate by 2024. We are very pleased to have accomplished this goal ahead of expectations.

Before providing additional detail on our operations and outlook, I'd like to take a moment to address the RADV final rule released Monday. I want to start by emphasizing the strength of the Medicare Advantage program, supported by a value proposition that is superior to fee-for-service Medicare. 30 million seniors have chosen to enroll in MA, of which nearly 34% identify as rational and ethnic minorities. The MA program delivers high-quality and improved health outcomes, resulting in a 94% satisfaction rate and lower total cost of care through improved care coordination providing savings to the Medicare program while helping seniors achieve their best talent.

The strength and support of MA is an important backdrop as we talk about a long-awaited final RADV rule. I'd like to reiterate Humana's core belief when it comes to RADV. Namely, we believe risk adjustment is an important element of the program and incentivizes plans to cover all individuals regardless of health status. We have long supported CMS' desire for greater transparency through auditing, and we'll continue to partner with CMS to promote program integrity. We strive to have a fair, compliant and transparent system.

While we're still reviewing the final rule and considering its impact, I will share some of our initial observations. First, we support CMS' decision not to extrapolate the result of any audit payments for the years prior to 2018. As CMS acknowledged auditing such as time periods represent a unique challenge that may produce results that are not truly reflective of the plans compliance or coding accuracy. Important part of RADV ruling is the audit methodology. Therefore, we look forward to working with CMS to learn more about the methodology, including contract selection, sampling and extrapolation as a rule did not provide the details needed to fully understand the potential impact of the future audience.

And finally, we are disappointed CMS' final rule did not include a fee-for-service adjuster in the process, which we believe is necessary to determine appropriate payment amounts to MA organizations. We are considering all our options to address our challenges this admission and obtain clarity about our compliance obligations.

With that said, we are committed to working productively with CMS to ensure the integrity of the program is maintained, and beneficiaries do not face higher costs and reduced benefits as a result of this rule.

For years, MA has been an example of a successful public-private partnership that works for Medicare beneficiaries, providers and taxpayers. And we're committed to working with CMS on a path forward to ensure that MA continues to be an option that millions of seniors have come to depend on.

Now turning to an update on our operations and outlook. We entered 2023 in a position of strength. Industry leader in the delivery of senior-focused integrated value-based care, delivering high-quality outcomes at a lower cost. Our defocus on value-based care, both through our CenterWell platform and our highly diversified value-based care solutions and locally oriented provider relationships is 1 of the differentiated capabilities that gives Humana a durable competitive advantage.

We closed 2022 with 70% of our individual MA members engaged in value-based arrangements, which incentivizes providers to comprehensively manage patient needs and reduce total cost of care. Our extensive experience in value-based care combined with our use of deep analytics and digital capabilities, first-mover deployment of interoperable solutions as well as our customer-centric products and solutions that sets Humana apart from peers. We believe these differentiated capabilities have contributed to our durable success in quality and customer experience as demonstrated by 5 consecutive years of leading STARS results, and individual MA membership growth of 10.4% on a 4-year compounded annual growth rate from 2018 to 2022 as compared to industry growth of 9.7%.

We complemented our differentiated capabilities with targeted investments and benefits, marketing and distribution for 2023, which has accelerated the strong momentum in our MA franchise. The improved plan designs have resonated with consumers and brokers resulting in our above industry growth expectations of at least 625,000 members for the full year.

Our 2023 growth outlook includes strong growth in the D-SNP space, where we have grown 72,000 members as of January, a 50% increase over 48,000 members added in the 2022 AEP. And importantly, the majority of our growth for 2023 is coming from the larger non-D-SNP space. We added approximately 422,000 non-D-SNP members through 2023 AEP, a significant increase from the 90,000 added in 2022 AEP, and representing an impressive 10% year-over-year growth in non-D-SNP membership.

We achieved our strongest growth in states with robust or growing value-based provider penetration. For example, our top states by absolute growth were Texas, Georgia, Florida and Illinois, which are highly penetrated value-based markets. Together, they grew 163,000 members in 2023 AEP, a 450% increase over the 29,000 members achieved in those states last year.

The robust membership outlook reflects high-quality growth, with retention improving over 200 basis points year-over-year better than our initial assumption of 100 basis points improvement. We are pleased to see our external call center partners improve retention by 380 basis points year-over-year, reflecting their enhanced focus on quality and customer satisfaction.

In addition, approximately 50% of our new sales reflect members switching from competitor MA Plans, which was higher than anticipated and significantly improved from the 30% experienced in 2022. We also saw a shift in our overall sales channel mix to higher-quality channels. Our internal sales channel and our external field broker partners represented 53% of total sales in the 2023 AEP compared to 44% last year. As shared before, these channels drive better engagement with members leading to greater planned satisfaction, retention and lifetime value.

Our strong 2023 membership growth was broad-based across our geographic footprint and benefits not only our MA business, but also our growing and maturing payer agnostic CenterWell platform, enhancing our ability to drive more penetration and integration of our CenterWell assets.

Our primary care organization also experienced strong growth during AEP and is expected to add 8,000 to 10,000 new patients across our de novo and wholly owned centers. And we are happy to share that nearly 60% of these new patients had appointments scheduled as of December 31. This is a key metric for us to measure the engagement level of new members and engagement is a key driver of retention. For the full year, we expect to grow patient panels by 20,000 to 25,000 through organic growth and programmatic M&A, meaningfully higher than the approximately 13,500 patient growth experienced in 2022.

Our center expansion remains on track as we ended 2022 with 235 centers and are scheduled to open an additional 10 to 15 in the first quarter alone. We expect to come in, in the near to high end of our previously communicated annual center growth of 30 to 50 in 2023, through a combination of de novo build and programmatic M&A.

In the Home, we have continued to expand our value-based model, which coordinates care and optimizes [standard] across home health, DME and infusion services. We are now supporting approximately 15% of our MA members with the model, expanding coverage to an additional 433,000 members during the fourth quarter. We remain on track to cover approximately 40% of our MA members with a fully based value-based model by 2025.

In addition, as previously shared, we are implementing some of these capabilities on a stand-alone basis to accelerate value creation. We rolled out the home health utilization and network management capabilities to 1.4 million members, bringing the total of covered members to 1.9 million, creating incremental enterprise value in advance of the fully value-based market rollout.

Finally, in our Pharmacy business, we once again increased our industry-leading mail order penetration levels in 2022, driving 38.6% penetration in our individual MA business, a 40 basis point increase over 2021. We anticipate maintaining this industry-leading position in 2023 as we further invest in the consumer experience and encourage the continued use of mail order, despite comparable co-pays in the retail setting beginning this year.

Before turning it over to Susan, I am excited to be able to speak to the senior leadership appointments we announced this morning. Dr. Sanjay Shetty is joining Humana as the President of CenterWell effective April 1. This newly created role comes as we continue to meaningfully expand our CenterWell capabilities, strengthening our payer agnostic platform and integrating the clinical experiences for patients across the CenterWell platform.

Sanjay comes to Humana from Stewart Health Care Systems, where he currently serves as the President. He will draw on his extensive experience leading a large health care system as well as his deep understanding of technology and application of data and analytics and modernizing workflows to accelerate the integration of our CenterWell assets. Sanjay's addition to the management team. He brings new and differentiated skills with extensive health care experience across a broad spectrum, including Medicare, Medicaid, physician groups and value-based care, and we are excited to have him on board as the President of CenterWell.

In addition, we are thrilled to announce that George Renaudin has been promoted to President of Medicare and Medicaid and added to the management team effective immediately. George has been integral to our success of the company joined and having joined the company team in 1996, spending the last 26 years dedicated to core operations of our Medicare business. Bringing Medicaid under his leadership complements his current responsibilities for the operations supporting more than 5 million Medicare Advantage and Medicare Supplement members.

With the addition of Sanjay and George to the management team, we have closed our search for the President of Insurance. We are confident that the depth of talent we now have in both the management team and across the broader leadership within the organization positions us well to continue to execute against our enterprise strategy. As with any company of our size and caliber, we will continue to evaluate strategic additions to and the evolution of our leadership team as we advance our strategy to develop strong synergistic growth across the enterprise.

In closing, I would again reiterate that we are entering 2023 in a position of strength. The strength is bolstered by Humana's differentiated capabilities and grow our payer-agnostic platform. And underpinned by the strong fundamentals in the Medicare Advantage industry. Importantly, the robust membership growth and financial outlook for 2023 puts us on a solid path towards our mid-term EPS target of $37 in 2025. We look forward to providing additional updates on our progress towards our mid- and long-term targets throughout the year.

With that, I'll turn the call over to Susan.

Susan Marie Diamond - *Humana Inc. - CFO*

Thank you, Bruce, and good morning, everyone. Today, we reported full year 2022 adjusted earnings per share of $25.24, ahead of our expectations of approximately $25 and representing a compelling 22% growth year-over-year. As Bruce shared, we delivered this impressive earnings growth while making significant advancements in our strategy, including a quicker-than-anticipated return to above-market individual Medicare Advantage membership growth for 2023 and further advancement of our CenterWell platform.

Before discussing details of our performance and outlook, I would note that we realigned our portable segments in December, moving to 2 distinct segments, Insurance and CenterWell. I will speak to our 2022 results and 2023 outlook in terms of the new segment structure with references to the old segments to provide clarity as needed. I will start by discussing our fourth quarter results and underlying trends before turning to our 2023 expectations.

We reported fourth quarter adjusted EPS of $1.62, above internal expectations and consensus estimates. Results for our Insurance segment were modestly favorable to expectations. As recently shared, total medical costs in our Medicare Advantage business ranged slightly above previous expectations during the fourth quarter, driven by higher-than-anticipated flu and COVID costs as well as higher reimbursement rates implemented for 340B eligible drugs.

Collectively, these items had an impact of approximately 80 basis points on the fourth quarter benefit ratio for both the Insurance segment as well as the previous retail segment. Importantly, these are discrete items in the quarter and do not have a carryover impact into 2023. Excluding these items, total medical costs in our Medicare Advantage business were modestly below our previous expectation.

Our Medicaid business continued to perform well in the quarter with lower-than-anticipated medical costs. In addition, the favorable utilization seen throughout the year in our commercial group medical and specialty businesses persisted in the fourth quarter.

All in, excluding the discrete impacts related to flu, COVID and 340B I just described, medical cost experienced in our insurance segment were favorable to expectations in the quarter, continuing the trends experienced throughout the year. This segment also benefited from administrative cost favorability driven by our ongoing cost discipline and productivity efforts while also covering incremental marketing spend.

Within our CenterWell segment, each business performed largely in line with expectations in the fourth quarter. Our Primary Care organization continues to improve the operating performance in our wholly owned centers and we're pleased to report that we increased the number of centers that are contribution margin positive from 88 at the end of 2021 to 110 at year-end 2022, a 25% increase year-over-year.

In addition, we increased the number of centers that have reached our $3 million contribution margin target from 18 in 2021 to 31 at the end of 2022. In our de novo centers, we grew over 9,000 patients in 2022 or 91%, while our de novo center count increased by 18 or 56%. As Bruce shared, we expect both center and patient growth to further accelerate in 2023. In the Home, total admissions in our core fee-for-service home health business were up 9.1% year-over-year for the fourth quarter and up 6.3% for the full year in line with our expectations of mid-single-digit growth.

In addition, we continue to expand our value-based model at the expected pace. We implemented the full value-based model in both Virginia and North Carolina in 2022 and ending the year covering just over 760,000 members or 15% of our Humana MA members, up from 5% coverage in 2021.

Finally, our Pharmacy results remain strong, reflecting industry-leading mail order penetration at 38.6% for our individual Medicare Advantage members. The benefits of mail order extend beyond our pharmacy operations, leading to better medication adherence and health outcomes, benefiting our members and health plan. As an example, members who utilize CenterWell pharmacy demonstrate medication adherence rates ranging from 650 to 840 basis points higher than we see in traditional retail pharmacies for cholesterol, blood pressure and diabetes treatments.

Now turning to our 2023 expectations and related assumptions. Today, we provided adjusted EPS guidance for 2023 of at least $28. This represents 11% growth over 2022, which is in line with our previous commentary and overcomes a headwind of approximately $0.92 or 3.6% related to the divestiture of a 60% interest in Kindred Hospice in August 2022.

Our 2023 outlook reflects top line growth above 11%, with consolidated revenues projected to be north of $103 billion at the midpoint driven by growth in our individual Medicare Advantage, Medicaid and CenterWell businesses. These increases were partially offset by the divestiture of a 60% interest in Kindred Hospice, and expected declines in our Group Medicare Advantage, commercial group medical and PDP membership. At this time, we expect first quarter earnings to represent approximately 35% of full year 2023 adjusted EPS.

I will now provide additional detail on the 2023 outlook for both our business segments, starting with Insurance. As Bruce discussed, we anticipate individual Medicare Advantage membership growth of at least 625,000 in 2023, a 13.7% increase year-over-year. We added approximately 495,000 members during the annual election period and anticipate continued strong growth for the remainder of the year.

Touching on Group MA, we continue to expect a net reduction of approximately 60,000 members in 2023. This reduction is primarily driven by the loss of a large group account partially offset by expected growth in small account membership. We remain committed to disciplined pricing in a competitive group Medicare Advantage market.

For our PDP business, we now expect a membership decline of approximately 800,000 members for 2023, an improvement from our pre-AEP estimate of a 1 million member reduction. This improvement was driven by better-than-expected sales and retention in our Walmart Value plan. We are committed to providing affordable coverage for beneficiaries while also improving the contribution from our PDP business and remain focused on creating enterprise value by driving mail order penetration and conversion to Medicare Advantage.

We are projecting approximately 80,000 of our PDP members to convert to a Humana Medicare Advantage plan in 2023, which represents a disproportionate share of all Humana PDP members who are expected to switch to a Medicare Advantage plan in 2023.

In our Medicaid business, we anticipate that our membership will increase 25,000 to 100,000 members in 2023. This change reflects membership additions associated with the start of the Louisiana contract which went live January 1, as well as the Ohio contract, which began today. We expect to add approximately 140,000 members in Louisiana and 65,000 members in Ohio at implementation with Ohio membership ramping to 130,000 by year-end and to a total of 225,000 in 2024.

The 2023 membership gains in Louisiana and Ohio will ultimately be offset by membership losses resulting from redeterminations beginning April 1, which will continue for 12-month. We are proud that our Medicaid footprint will now span 7 states and cover over 1 million members, a strong platform that we have established largely through organic growth. We intend to continue to invest to grow our platform organically and actively work towards procuring additional awards and priority states.

Finally, we anticipate the total commercial medical membership including both fully insured and ASO products will decline approximately 300,000 members in 2023 as we remain focused on optimizing our cost structure and margin in this line of business.

The insurance segment revenue is expected to be in a range of $99.5 billion to $101 billion, reflecting an increase of nearly 13% year-over-year at the midpoint. The year-over-year change includes the impact of the phaseout of sequestration relief beginning in the second quarter of 2022 and as well as the impact of changing member mix within our Medicare Advantage business.

This segment benefit ratio guidance of 86.3% to 87.3% is 20 basis points higher than the 2022 benefit ratio of 86.6% at the midpoint, driven by the targeted investments made in our Medicare Advantage plan designs in 2023 and as well as Medicaid growth, which carries a higher benefit expense ratio.

Importantly, we have assumed a normalized trend into 2023 and including the expectation that provider labor capacity will improve modestly throughout the year. In addition, we have assumed the flu favorability seen to date in the first quarter is offset by higher flu costs in the fourth quarter. In summary, we are guiding to insurance segment income from operations in the range of $3.2 billion to $3.5 billion for 2023, an increase of more than 12% over 2022 at the midpoint of the range.

For our CenterWell segment, we expect EBITDA in the range of $1.3 billion to $1.45 billion for 2023, a slight decrease from 2022. The 2023 outlook reflects the impact of the divestiture of a 60% interest in Kindred Hospice in August 2022, which created a $150 million year-over-year headwind, largely offset by continued growth in our Primary Care, Home and Pharmacy businesses.

In our core fee-for-service home business, home health admissions are expected to be up mid-single digits. While we have strategies in place to continue to take share in fee-for-service Medicare, we do acknowledge it is a shrinking market with the increasing penetration of Medicare Advantage. Accordingly, our projected admission growth for 2023 reflects a slight decline in fee-for-service Medicare admissions year-over-year, more than offset by strong growth in Medicare Advantage.

In addition, CenterWell Home Health is focused on increasing nursing capacity through recruiting and retention initiatives. Our voluntary nursing turnover improved from 31.9% in 2021 to 30.6% in 2022. We continue to invest in clinical orientation and mentors and technology focused on reducing administrative tasks and drive time for clinicians, which we expect to drive further improvement in nurse recruitment and retention.

With respect to our value-based home model, we expect to expand coverage to approximately 1 million additional members by year-end 2023, 800,000 of which are currently served under the utilization and network management model.

In our Primary Care business, as Bruce shared, we expect significant center expansion throughout the year through a combination of de novo bills under our joint venture with Welsh Carson as well as programmatic M&A. All in, we anticipate adding nearly 50 centers in 2023, an increase of approximately 20%. In addition, we expect to add 20,000 to 25,000 patients during the year in our de novo and wholly owned centers, representing nearly 12% growth year-over-year.

Finally, our pharmacy business will benefit from the significant growth in individual Medicare Advantage membership in 2023, as we anticipate maintaining our industry-leading mail order penetration rate.

From an operating cost ratio perspective, we are guiding to a consolidated operating cost ratio in the range of 11.6% to 12.6% for 2023, a decrease of 100 basis points at the midpoint from the adjusted ratio of 13.1% in 2022. This decrease reflects the divestiture of a 60% interest in Kindred Hospice in August of 2022, which has a higher operating cost ratio than the company's historical consolidated operating cost ratio as well as the incremental run rate impact of our value creation initiatives.

Touching now on investment income and interest expense. We anticipate investment income will increase approximately $450 million in 2023, resulting from the higher interest rate environment, coupled with the impact of approximately $100 million in realized losses experienced in 2022 that are not expected to recur. From an interest expense perspective, while the majority of our debt is fixed rate, we do expect interest expense to increase approximately $110 million year-over-year.

I will now briefly discuss capital deployment for 2023. We will continue to prioritize investments to drive organic growth. From an M&A perspective, we remain focused on opportunities to enhance our CenterWell capabilities with a particular focus on growing our Primary Care and home businesses.

And finally, we recognize the importance of returning capital to shareholders and expect to maintain our strong track record of share repurchases. We will consider the use of accelerated share repurchase programs as well as open market repurchases to ensure we maximize value for our shareholders. We also recognize that dividends are important to our shareholders, and we are committed to growing our dividend.

In closing, I would like to echo Bruce's sentiment that we enter 2023 in a position of strength. The strong earnings growth delivered in 2022, combined with the robust membership growth and financial outlook for 2023 increases our confidence in the midterm target of $37 in 2025. We look forward to providing continued updates on our progress towards our mid- and longer-term targets throughout the year.

With that, we will open the lines up for your questions. In fairness to those waiting in the queue, we ask that you limit yourself to 1 question. Operator, please introduce the first caller.

QUESTIONS AND ANSWERS

Operator

And our first question will come from Josh Raskin of Nephron Research.

Joshua Richard Raskin - *Nephron Research LLC - Research Analyst*

I want to focus on CenterWell, and I understand the decline from the hospice sale. But maybe if you could give us some color on what's the organic growth rate around both the revenues and EBITDA. And then if you could talk about your recruiting initiatives and how you're trying to bring physicians into the centers.

Bruce Dale Broussard - *Humana Inc. - President, CEO & Director*

Yes. Josh, thanks for the questions. On the recruiting side, we do it both nationally and locally. And what we're finding in the -- we have a dedicated team also to the recruiting area. What we're finding in the recruiting is that we are really the younger population we're able to recruit, too, and then also the older population, the experienced ones that are really looking to change their approach in clinical area and specifically around moving from an E&M code driven primary care billing to more of a value based.

And what we're finding is once we -- they are experienced with the value base, the retention side is much greater because it's a better quality of life for them. But more importantly, it's also a much aligned with what they went to school for around proactive care and care that is more oriented to prevention as opposed to just the treatment side. So through a centralized approach and also oriented to locally, but really oriented to people that are looking for value-based payment options.

Susan Marie Diamond - *Humana Inc. - CFO*

And Josh, to address your other question related to just the organic growth that we anticipate for the CenterWell segment. So in total, the segment is expected to grow revenues about 6% year-over-year with pharmacy slightly above that number based on the strong individual MA growth, although they're also impacted by the decline in the PDP membership.

The home is slightly down, and that's again reflective of the growth that I had mentioned in my commentary about the core fee-for-service expansion [as our] growth as well as the expansion of the value-based model, but obviously offset by the disposition of the 60% interest in hospice and the movement of that line of business to below the line is a minority investment.

For CenterWell Primary Care, that business continues to grow. But as you know, the majority of the de novo growth is off balance sheet as part of the Welsh Carson deal. So also isn't reflected in our actual revenue growth and EBITDA. It's going to be reflected in that minority investment as well. But specifically, the segment in total is expected to grow 6% for the on-balance sheet portion.

Operator

And our next question will come from A.J. Rice of Credit Suisse.

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

Okay. Thanks for the comment on the RADV rule and I know that's still under review by you guys and the industry. One of the things in some of the data that was released by Kaiser and others running up to the rule release was some data suggesting various error rates on audits done on

results from the 2011 to 2013 time period. And one thing that got some play was the fact that Humana seem to have a little higher audit rate -- error rate or somewhat higher error rates then the some of the peers. I know that was years ago.

I'm sure the entire industry has invested in making sure that they do better in future audits. But I'm wondering if you guys could give us your perspective on that and any initiatives you've done to try to make sure that going forward, that won't be an issue.

Susan Marie Diamond - *Humana Inc. - CFO*

A.J. Thanks for the question. In terms of the variation that was reflected in the report that came out I would say, first, we don't have access to the data, obviously, to be able to really evaluate or assess those differences, so really can't comment on the variation. More generally, I would just say that we don't have any reason to think that the inherent error rate within the Humana population would be meaningfully different from others. And so maybe just reflective of the audit selection and process that they've used historically.

In terms of the question of what we might expect going forward, I would say that, that is also impossible to really assess. Even in the period they have audited, they have used different methodologies over that period. And as you saw in the final rule that came out earlier this week, they did not provide specificity on what the audit methodology will be going forward.

And so the error rate that you might expect is going to be highly dependent on audit methodology and extrapolation that they ultimately define. And so that is one of the things that we look forward to working with CMS on, to better understand to fully assess what might be expected going forward.

Operator

Justin Lake of Wolfe Research.

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

I guess, first, I'll just follow-up on A.J.'s question and then ask my own. Maybe the -- I assume -- I know CMS methodology changing and they didn't give a lot of specificity, but I kind of would assume an error rate is an error rates. So maybe you can just tell us, I mean, even CMS has said error rates for the industry have improved. So one, are you doing your own audit to see how this has trended over the last 10 years? Maybe you can give us some color on how the error rate, forget about extrapolation and all that, but just how the error rate in these in your own audits might have been trending over that period of time.

And then my question would just be, as a follow-up. The -- as you think about CMS that 2018 will be the first time they use extrapolation on an audit. Whatever that error rate is, can you give us some color in terms of how you share that with investors. And more importantly, kind of how you would think about it from a bidding perspective? Would you kind of take a onetime charge on something that was from 2018, whatever that repayment might be? Would you build it into the bids going forward as kind of a reserve and just assume it's a lower revenue number or premium number like a rate cut? Can you give us some color on that as well?

Susan Marie Diamond - *Humana Inc. - CFO*

Sure. Justin, to your first question about just broadly how to think about how error rates may have trended over time. What I would say is that generally, the growth in value-based provider penetration as well as the increase activity within in-home assessments over that time frame as well as just the normal course activities that all health plans undertake to and as part of Medicare Risk Adjustment, frankly, all work to improve accuracy. And so I would expect that some of those programs have grown, particularly value-based care and home assessments that we would see hopefully some improvement relative to those initiatives.

But in terms of what might be happening in the broader sort of and much larger organic base of provider claims, that's difficult to say because, again, we don't have that information. And it will ultimately depend on how the audit methodology is defined in order to fully assess the impact of that.

In terms of how we might think about the impact of this from 2018 and forward, I would say that from a 2024 bidding perspective, based on what we know today and given that the '24 bids are due in just a few months, I would say it's unlikely that there would be any impact to '24 bids. But we'll certainly need to look to see if CMS provides any guidance in the advanced notice and bid instructions given just the uncertainty that exists regarding how the contract selection and audit methodologies will be defined in the future.

But our focus will continue to be on delivering value and strong value within our M&A claims to members, including the goal of stable premiums and benefits in 2024. So we look forward again to working with CMS to better understand the planned audit methodology going forward and assessing any future impact, but unlikely that, that will be finalized in time for the '24 bids.

Operator

And our next question will come from Kevin Fischbeck of Bank of America.

Kevin Mark Fischbeck - *BofA Securities, Research Division - MD in Equity Research*

A little more color on your insurance MLR guidance. I think in your comments, you mentioned that it's up in part due to the benefit design improvements. I guess -- I was under the impression that you guys were trying to target stable margins on the MA business. So just want to understand that nuance.

And then you mentioned Medicaid pressure due to new contracts. So I was wondering if there's anything in there about redeterminations? And then finally, any color on commercial would be great.

Susan Marie Diamond - *Humana Inc. - CFO*

Kevin, this is Susan. Yes. So in terms of the MLR guide for 2023, the way you should think about it is that we did through our value creation initiative, create capacity with the enterprise to fund those targeted investments without impact to overall earnings and EPS.

But keep in mind that the enterprise savings that were generated were across the entirety of the enterprise. They wouldn't have all been generated by the Medicare line of business. And so given all of that investment was redirected to Medicare, you would see some impact to the MLR, all other things being equal for Medicare.

And then as always, you have to consider, given the growth that we saw and some of the dynamics that Bruce mentioned about new members, switching members in retention, all of those would go into our estimates for MLR for the year as well.

Outside of just the Medicare trend, as you pointed out, the Medicaid growth will also impact the MLR; Medicaid in general has a higher MLR. And given the growth that will happen into (inaudible), I believe in Ohio, that will certainly impact it and be mitigated over the course of the year through redeterminations. And as we've commented previously, the members who had access Medicaid through the deferral of the redetermination did tend to be lower acuity and higher contributing. So as they roll off, that would have an impact to the Medicaid MLR as well.

So those, I would say, are the 2 main drivers as well as just more generally, our continued approach of a more conservative initial guide as we set expectations with the -- they intend to certainly meet and hopefully exceed those expectations.

Operator

And our next question will come from Stephen Baxter of Wells Fargo.

Stephen C. Baxter - *Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst*

I wanted to ask about retention in Medicare Advantage. I think you said you more than doubled the improvement that you targeted for 2023. So it sounds like you've gotten retention back to where you would have initially planned heading into open enrollment for 2022.

I was hoping you could talk about what your outlook is for retention as you continue to evolve your channel strategy. Do you think retention is stable from here? Do you think it can improve? And if it can improve? Any sense of what the pacing would look like would be great.

Bruce Dale Broussard - *Humana Inc. - President, CEO & Director*

Thanks for the question. Yes, as you articulated, we're very happy about the 200 basis point improvement in the retention this year. It is a combination of both internal work and the combination of our partnership with the (inaudible) channel, as they increased 350 basis points.

As we look forward, it's probably going to be more stabilized as we think about it with some improvement, we'll continue to work on it. But with the large increase in improvement in the channel outside that really contributed to the 200 basis points. And I don't know if you're going to see that large an improvement in 2023 and 2024.

Operator

This is your operator. Unfortunately, you could not hear me speaking. I have introduced Scott Fidel twice. Scott, your line is open.

Scott J. Fidel - *Stephens Inc., Research Division - MD & Analyst*

Getting here either of those first introductions. Can you hear me okay?

Susan Marie Diamond - *Humana Inc. - CFO*

Yes.

Scott J. Fidel - *Stephens Inc., Research Division - MD & Analyst*

Okay. Okay, got you. I wanted to follow-up on just the home outlook and appreciate the details you did give. Just interested, just given some of the moving pieces with the hospice divestiture. When just looking at the home health business, can you give us your view on what you're expecting the revenue growth trends to be there when considering some of the volume indicators that you gave us? And then also just interested in your expectations for home health margins in 2023. Just when considering both the final fee-for-service rates and the shift that's playing out to value-based care.

Susan Marie Diamond - *Humana Inc. - CFO*

Sure. Scott, this is Susan. So in terms of revenue trends, because of the hospice divestiture, you will see a decline year-over-year. It's just over $100 million decline. We have a meaningful offset in the growth of the value-based model, in particular, which is a risk-based capitated arrangement with the health plan. And so as we significantly expand the coverage of that to 1 million members that does drive meaningful revenue appreciation,

consider that close to $1 billion for 2023. That's offsetting what otherwise would have been pressured from the 60% divestiture of the hospice asset.

From a EBITDA contribution, you can think of, again, this segment is being down year-over-year, and that's primarily a function of that higher-margin hospice divestiture being replaced with the less mature value-based model contribution. We expect increasing contribution in markets over time. They don't start immediately at full impact.

And so the value-based model expansion, you can think of is closer to breakeven in 2023. And then that being offset by the loss of the hospice earnings in our reporting. And I would say on the core home health services, we do expect, I would say, relative margin stability. We'll certainly continue to watch labor trends and make some further investments in nursing recruiting and retention, as I mentioned in my commentary, but I'd say relatively stable margins in the home health business.

Operator

And our next question will come from Stephen Baxter of Wells Fargo.

Stephen C. Baxter - *Wells Fargo Securities, LLC, Research Division - Senior Equity Analyst*

I've had my questions, so I'm happy to give you the floor back and move to the next person.

Operator

Our next question will come from Gary Taylor of Cowen.

Gary Paul Taylor - *Cowen and Company, LLC, Research Division - MD & Senior Equity Research Analyst*

I wanted to ask about the '23 MLR guidance, but maybe come at it from the other side of the angle from what Kevin asked. We tried to look back at years in the last decade where you had really above-trend enrollment growth like 2014, '15 and '19.

And generally, MLR was up in those years, although 2019 was probably mostly the HIF holiday. But I'm just trying to think through your commentary about retention being higher, which should imply keeping more comprehensively coded patients and 50% of enrollment from plan switching, which should also imply more comprehensively coded patients. So I'm just wondering if inherent in the MLR guide is an assumption that your new class of '23 is better profitability than typically you would ascribe to a new class of patients and any implications on kind of that margin improvement progression we would expect into '24.

Susan Marie Diamond - *Humana Inc. - CFO*

Gary, great question. So there are a number of things that will impact the MLR as a result of the membership mix. As you said, the higher than typical rate of members -- new members coming from competitor MA plans would generally be viewed as positive. Those numbers do tend to be contribution margin positive even in the first year. We've many times commented on, in general, when you think of the full new cohort of new members as being breakeven from a contribution margin basis, but that's based on that historically lower switching rate.

So the fact that we saw more switchers, incrementally, that would be viewed as positive. As you said, relative to our previous expectations, at least, the higher retention is certainly positive from a contribution margin perspective as those are going to be the most impactful from a current year contribution standpoint.

The other 2 things I would say, work negatively against MLR. One is one plan, in particular, the plan where we offered a meaningful Part B giveback. We do expect that, that plan will attract an overall lower acuity membership given the plan design and the way it's structured, and we did see stronger growth in that plan than we had originally expected. So again, that relative to all other members would likely be a negative to MLR.

And then finally, I would say the plan-to-plan switching that we saw this year, and we commented on this at JPMorgan as well. for the existing members that we do have, we did see more members switch to another Humana offering than we had initially anticipated. Typically, that's where they will see a richer plan in market and select that plan. So while still positive and more so than an otherwise new member, year-over-year, they would see less contribution given the planned change that they initiated.

And the last thing I'll just point out that is a bit unique this year is in order to make the level of investment that we did in our Medicare offerings the way the bid dynamics work, we have to create savings for -- relative to A&B cost to fund those additional benefits and recall that CMS shares in those savings through the rebate. And so in order to invest $1 billion in benefits, you have to actually save more than that and then share some of that with CMS.

And so the implication of that is otherwise increased to MLR relative to what it would have been at a lower investment level. So all of those things are contemplated in our current year guide as well as, as I said a moment ago, just our continued approach of taking a conservative view of the guidance at the beginning of the year.

Operator

And our next question will come from Nathan Rich of Goldman Sachs.

Nathan Allen Rich - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

I wanted to go back to RADV, if I could. It looks like the elimination of the fee-for-service adjuster, is set to go into effect. I guess, how significant of an impact could that element have relative to some of the other factors you mentioned where there seems to be a bit more uncertainty around contract selection and sampling methodology?

And then, Susan, I think you had previously talked about potential for the industry to litigate the outcome of the final rule to try to resolve some of these uncertainties. It'd be great to get your kind of updated thoughts on how you think that process could play out?

Susan Marie Diamond - *Humana Inc. - CFO*

Sure, Nathan. So I would say, as we think about the ruling, as Bruce mentioned, the fact that they will not be extrapolating to periods of 2017, and prior we certainly view as positive and we would consider the exposure for the audits that have been completed for those periods to be immaterial. So that was definitely positive.

As we think about what CMS has shared for 2018 and forward, and as we said in our commentary, it will be -- we will need to evaluate, obviously, the audit selection methodology and extrapolation methodology. And also understand our compliance concerns as part of our normal core MRA activities and as we do that we continue to evaluate all of our options to ensure that the omission of a fee-for-service adjuster and the resulting impact is addressed.

And so again, at this time, that's really all we can say. There's going to have to be additional collaboration with CMS to better understand some of the go-forward activity, but we just continue to -- and we'll continue to evaluate all of our options to address the primary issue of the lack of acknowledgment of the need for a fee-for-service adjuster.

Operator

Our next question will come from Lisa Gill, JPMorgan.

Lisa Christine Gill - *JPMorgan Chase & Co, Research Division - MD, Head of U.S. Healthcare Technology & Distribution Equity Research and Senior Research Analyst*

Susan, I was wondering if you could just maybe discuss your expectations around the number of patients that will be in capitated relationships for 2023. And maybe just overall, the number that will be in any type of risk relationships as we think about 2023?

Susan Marie Diamond - *Humana Inc. - CFO*

Sure. Lisa, I would say that -- we would probably expect relatively stable percentages and as we've disclosed historically, you consider about 1/3 of our membership in full capitated arrangements another 1/3 in some form of value-based arrangement, and then the final 1/3 in more fee-for-service type arrangements.

And just given the strong growth, our goal every year is to a minimum maintain that penetration and ensure that the new members who are enrolling with us get to that penetration level. So given the strong growth this year, we'll certainly have to evaluate that.

But as Bruce said, we saw very strong growth in highly penetrated markets. So hopefully, that may be a bit of a tailwind as respect to those ratios. But generally, you can -- given the high penetration already, the goal is to maintain that as we continue to grow at or above the market rate.

Lisa Christine Gill - *JPMorgan Chase & Co, Research Division - MD, Head of U.S. Healthcare Technology & Distribution Equity Research and Senior Research Analyst*

And if you see better penetration, can you just remind us, will that help to improve the initial guidance that you've given here around medical cost trend for 2023?

Susan Marie Diamond - *Humana Inc. - CFO*

I would say we've evaluated the 2023 membership growth and the quality of that. And as we've said earlier in the commentary, net-net, you can think of that all in as net positive relative to what we would have previously expected, but immaterial really to our overall estimates for 2023.

And certainly, we'll evaluate the claims trend as we do every year. And if we do see some positivity, we'll certainly keep you apprised. But I would say from the growth itself, while positive, would not be considered material to our overall estimate.

Operator

And our next question will come from Michael Ha of Morgan Stanley.

Hua Ha - *Morgan Stanley, Research Division - Equity Analyst*

Just a quick follow-up on Susan's response to Gary's question and then the quick one on value creation plan. So at least Susan mentioned existing MA members switching to a plan with a higher Part D rebate had a meaningful impact MLR. Just wondering how many approximate members is related to a larger that impact MLR? And then quickly on the value creation plan. I understand it's tracking very well. I think on track to exceed $1 billion in savings. So that's great. And just a couple of questions, like how much in excess of $1 billion are you now targeting to save for '23?

And then now that AEP is over, you think about that $1 billion in relation to strong membership growth, increased planned investments in sales and marketing? And how does it compare to your original expectation? Are the investments tracking in line with the $1 billion?

Susan Marie Diamond - *Humana Inc. - CFO*

Mike, yes. And just to clarify, the enrollment in Part B plans was a broad comment. We saw a strong sort of choice within that product from new members. And I'm sure some of our existing members may have switched to those plans as well. But I would say the majority of the outperformance in that product was more related to new members than switching. But certainly, provides a different alternative in terms of the way the benefits, the guarantee Part B give back on the premium side, and there is a trade-off for the relative richness of the benefits relative to other plans.

So again, just based on, I would say, more of the acuity of the membership that we expect those plans to attract being lower is why I would say that, that would sort of all other things being equal, negatively impact the MLR that you would expect. The plan-to-plan change broadly is just recognizing that typically when a member changes plans, it's usually because they've identified a plan that has richer benefits that they will move to. And so year-over-year, their contribution, while positive, will just be less than it was in the previous plan.

In terms of the value creation plan, yes, as you said, we did outperform our initial goal of $1 billion. I would say you can think of that as sort of a 10% to 15% outperformance. As we mentioned, though, in 2023, we did plan for the intent to reinvest some of those savings into other admin categories and investments, particularly marketing and distribution with the intent of continuing to take progress on shifting some of our external call center market share back to our proprietary channels, which we've described historically is requiring some upfront investment, given that we fully fund the marketing for our proprietary channels we'll see lower commissions over time, but relative to the external channel, those costs are a little bit more front-loaded.

And so our 2023 plan does continue to contemplate that, increased investment in 2023, so that we can make further progress. Having said that, we will certainly evaluate the stronger-than-expected results that we've seen so far in 2023 overall, but also by channel and the team is currently evaluating all of the marketing metrics and developing sort of a point of view of how we will think about our go-forward plan, particularly for 2024 AEP and whether there's opportunity to optimize what we might have initially expected.

So more to come on that, but our [plan] does contemplate the same level of increased investment that we planned for at the time of our bids last year and the planned use of some of those value creation savings to fund that investment.

Operator

And our next question will come from Steven Valiquette of Barclays.

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

We talked about the MLR guidance for '23 a lot on this call so far. Just one other question around that sort of a clarification. But you mentioned that you expect the provider labor capacity to improve modestly throughout the year. Just wanted to get some quick clarification around that in terms of -- do you consider that to be a pent-up demand when you're referring to that?

And maybe just the other question would just be at the midpoint of the MLR guidance, are you assuming any sort of pent-up demand related to elective procedures or any other pent-up non-COVID care coming out of '22 that may have to be absorbed in '23 at the guidance midpoint.

Susan Marie Diamond - *Humana Inc. - CFO*

Steven, so as we talked about the MLR and specifically the mention of provider labor capacity, I would say that is more a broad belief that over time, we will see improved clinician labor capacity which, as we all know, has been impacted throughout COVID, and we believe still at lower levels

than we would have exchanged in the absence of COVID. So our belief is that over time, it won't be an immediate correction, but over time that we will see clinician labor capacity increase and that when we do additional utilization will also follow.

And I think as we've commented before, one of the spaces that we continue to see lower than historical utilization is in the observation space within the hospitals systems. Today, what we've seen throughout COVID is ER utilization and inpatient stays -- observation stays which you think of as a sort of shorter duration stays are materially lower, which makes sense as the hospitals would certainly look to maximize sort of the revenue within their beds for any given patient.

So we would expect a labor capacity increases. That will be 1 area where I imagine we will start to see some return to pre-COVID levels as there is sufficient capacity to support those additional patients in the facilities. So I would say it's not explicitly pent-up demand.

And based on all the analysis we've done, we don't believe there's a large amount of pent-up demand sort of that needs to work its way through the system. Historically, we have seen some evidence of that, but it's typically after a very large COVID spike where there's significant depressed non-COVID utilization, which fortunately we haven't seen for some time, and we are not forecasting that type of event to occur again in 2023.

So our guide does not have an explicit assumption around pent-up demand, but rather just taking the resulting sort of baseline trend we experienced in 2022. Increasing that for normal course trend as well as the expectation of some higher utilization as labor capacity returns. And as I mentioned in the commentary and expectation that flu will also see higher costs than we saw in 2022 as well.

Operator

Our next question will come from George Hill of Deutsche Bank.

George Robert Hill - *Deutsche Bank AG, Research Division - MD & Equity Research Analyst*

Susan, I hopped on a couple of minutes late. I was wondering if you could just spend another minute talking about what drove the increase cost in 340B and the duration of that for this year. And I guess I would just know -- I'm sure you guys thought it was a court ruling on Monday that looks like it's going to give the manufacturers more flexibility with which pharmacies they want to participate with and which drugs they kind of want to provide discounts around. So just kind of would love more color on kind of what happened in 340B and what you guys see going forward?

Susan Marie Diamond - *Humana Inc. - CFO*

Sure, George. So the impact that we saw in the fourth quarter of 2022 was a result of an increase in the ASP schedule. That was defined as for claims paid on or after September 28 of 2022. And there was no ability for CMS to provide any budget neutrality offset in 2022. And so the lack of a neutrality offset is what caused the higher cost that we incurred in the fourth quarter that we had not previously anticipated.

As you think about going forward in 2023, we will have that same higher ASP fee schedule in effect. However, CMS did implement a change in the outpatient conversion factor, which reduces the cost for other services and drive something much closer to budget neutrality, which is why you haven't seen ongoing run rate impact into 2023.

Operator

And our next question will come from Ben Hendrix of RBC.

Benjamin Hendrix - *RBC Capital Markets, Research Division - Assistant VP*

With regard to CenterWell, you've noticed focus on payer-agnostic platform, but you've also noted strong margin contribution from integration with your MA book. Can you remind us how you are prioritizing engagement with your MA plans versus carrier-agnostic development as you plan de novo center development going forward?

Bruce Dale Broussard - *Humana Inc. - President, CEO & Director*

Well, we actively pursue and engage other payers on this. We do believe that's an important part of our growth strategy and in addition, continuing to provide value back to the MA industry overall. But it is highly dependent on the growth of the plan. So this year, you saw significant growth as a result of our MA -- as the insurance side doing quite well. And so I would say our engagement is very broad and very oriented to continuing to be payor agnostic, but it's highly dependent on the insurance plans ability to grow.

Operator

Now I'm showing no further questions. I would now like to turn the conference back to Bruce Broussard for closing remarks.

Bruce Dale Broussard - *Humana Inc. - President, CEO & Director*

Thank you, operator, and thanks for your continued support. And most importantly, thanks for our 65,000 teammates that allow us to really report these wonderful results. As Susan and I have reiterated, we are entering 2023 with -- in a position of strength and look forward to continuing to provide you updates throughout the year on based on this strength. So thank you, and everyone, have a wonderful day.

Operator

I would now like to conclude today's conference. Thank you for participating. You may now disconnect.
