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HUM - Q4 2018 Humana Inc Earnings Call

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OVERVIEW:

Co. reported 2018 adjusted diluted common EPS of $14.55 and 4Q18 adjusted diluted common EPS of $2.65. Expects 2019 consolidated revenue to be north of $63b and adjusted diluted common EPS to be $17.00-17.50.

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PRESENTATION

Operator

Ladies and gentlemen, good day, and thank you for standing by. My name is Lulu, and I'll be your conference operator today. At this time, I would like to welcome everyone to the Humana Inc.'s Fourth Quarter 2018 Earnings Conference Call. (Operator Instructions) .

It is now my pleasure to turn today's call over to your host, Ms. Amy Smith, Vice President of Investor Relations. You may begin your conference.

Amy K. Smith *- Humana Inc. - Vice President, IR*

Thank you, and good morning. In a moment, Bruce Broussard, Humana's President and Chief Executive Officer; and Brian Kane, Chief Financial Officer, will discuss our fourth quarter 2018 results and our financial outlook for 2019. Following these prepared remarks, we will open up the line for a question-and-answer session with industry analysts. I would like to welcome our new Chief Legal Officer, Joe Ventura. Joe will be joining Bruce and Brian for the Q&A session.

We encourage the investing public and media to listen to both management's prepared remarks and the related Q&A with analysts. Additionally, we have posted supporting materials to our Investor Relations page for reference during Brian's prepared remarks.

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 fourth quarter 2018 earnings press release as well as in our filings with the Securities and Exchange Commission. Today's press release, our historical financial news releases and our filings with the SEC are all also available on our Investor Relations site.

Call 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*

Good morning, and thank you for joining us. Today, we reported adjusted earnings per share of $2.65 for the fourth quarter of 2018 and $14.55 for the full year, above our previous guidance of approximately $14.40, primarily due to favorable Medicare Advantage results.

We are pleased with the consistency of and ongoing improvement in our performance, which can be attributed to our focus on optimizing our core operations. Our desire to drive effective clinical outcomes is leading us to integrate health care with lifestyle. To that end, we are focused on 5 areas of influence: primary care, the home, pharmacy, behavioral health and social determinants. In 2018, we continued to make advancements in each of these 5 areas, and I'd like to briefly touch on each.

In primary care, Conviva continues to make operational improvements and, as expected, our 233 owned, joint-ventured and alliance clinics, the majority of which are payer-agnostic, including our 2 partners in primary care clinics inside Walgreens stores, experienced positive results in the annual election period or AEP. Humana MA membership grew over 9% in these clinics in the AEP, excluding the more mature Conviva clinics.

Regarding the home, we established an independent home health company, joining Kindred at Home and Curo, that provides significant overlap with our Medicare Advantage business. We are now implementing care and payment models oriented to patients with multiple chronic conditions in 5 pilot markets. We've optimized our ability to exchange key medical history with Kindred at Home. We used this information during the home health admission process to form the patient's treatment plan as we deploy evidence-based, disease-specific care plans to identify and prioritize the most impactful clinical interventions.

Additionally, Kindred at Home has selected HomeCare HomeBase as the electronic medical record and practice management system for both home health and hospice, and will begin implementing this system in 2019. This will accelerate our ability to proactively identify key clinical interventions while improving revenue capture and business and quality reporting.

Turning to Pharmacy. The integration of Pharmacy and Healthcare is an important part of managing chronic conditions as medication adherence and education result in a reduction in inpatient admissions, ER visits and how members engage with their primary care physician. This is especially important given Medicare members have 4 times the number of prescriptions as commercial members.

We continue to see industry-leading mail order penetration rates in both our Medicare Advantage and Medicare stand-alone Part D, or PDP, products. However, we acknowledge that PDP plans have become a commodity, as evidenced by Humana and others experienced significant declines in PDP enrollment during the recently completed AEP, with price leaders taking share.

You will recall that we pioneered the PDP market with the introduction of our low-price co-branded plan with Walmart. Others in the industry have now imitated this plan. While it will take time, we intend to stay competitive and are working through alternatives to change the value proposition and impact the market.

Transitioning to behavioral health. We recognize the significant impact mental health has on individual's physical health and well-being. To drive better clinical outcomes, we expanded our internal behavioral health model to our nearly 6 million TRICARE members in 2018. And we are now beginning to in-source our Medicare Advantage behavioral health offerings, beginning with Florida.

Lastly, regarding social determinants. We continue the work of our Bold Goal: to improve the health of the communities we serve 20% by 2020 and beyond by partnering with local community agencies and programs to expand access to critical support systems that address food and security and social isolation, among other endeavors. Seniors living in Bold Goal communities continue to outperform other communities we measure in terms of having fewer unhealthy days. For perspective, each additional unhealthy day a patient has is associated with approximately $16 higher medical cost per person per month.

In the spirit of our Bold Goal, our associates are empowered to speak up and help our members when they need it the most. As I've said before, associates in our call centers and at our primary care clinics learn far too frequently that a member has a lack of access to food and other critical resources. In response, these Humana associates proactively seek out our Bold Goal team and [they will] connect the member with local community resources to help them with food and other access issues. Taking this extra step has a positive and transformative effect on our relationship with the member and not only drives better member experience, but also leads to better health outcomes.

For instance, recently, a member who had just returned home after a week in the hospital due to a fall was surprised when one of our team members, on her own, showed up at her door with an assortment of fresh foods so she could stay healthy and out of the hospital. These actions aren't written in our company's policies and procedures, rather, they're ingrained in the culture, where our purpose goes beyond formal job descriptions.

Importantly, we also continue to advance our core operations in 2018. We returned to strong Medicare Advantage membership growth. We expanded our Medicaid operations as 1 of only 2 companies awarded a statewide Florida contract. And we exited our Individual Commercial business and the closed-block long-term care insurance policies.

As we celebrate our success as a company in 2018, we also celebrate our employees, without whom our financial and operational achievements would not have been possible. We are pleased that our strong performance will result in an increased incentive compensation for our employees at all levels across the organization participating in our expanded associate incentive program, which closely aligns compensation to the interest of our shareholders.

Turning now to 2019. We experienced meaningful tailwinds coming into the year, including, among others, the strong Medicare Advantage rate notice and health insurance industry fee, or HIF, moratorium, which allowed us to make significant investments in our products to benefit our members and drive improved health outcomes. These benefit enhancements, combined with our deepened broker relationships, led to the strong results in the recently completed annual election period, outpacing industry growth. We are projecting individual Medicare Advantage membership growth of 375,000 to 400,000 members, or 12% to 13% for the full year.

While the individual MA growth exceeded our initial expectations, the growth was still within the bounds of our operational capacity. As a result of previous investments, we are confident we have the appropriate infrastructure, risk management programs and predictive capabilities in place to manage this level of growth.

Preliminary data suggest that approximately 44% of our individual gross sales during the AEP came from competitor Medicare Advantage offerings. From a geographic perspective, we generally experienced widespread growth, but did grow disproportionately in key markets with higher-than-average industry or Humana penetration, including Florida, where we have a 5-Star plan, and Texas.

While it is evident the industry as a whole invested in benefits for the members in 2019, in great part due to the HIF moratorium, we believe that the return of the HIF in 2020 will negatively impact seniors across the nation in the form of reduced benefits and/or higher premiums. Accordingly, we are working with partners to urge Congress to take legislative action to repeal the HIF for 2020 and beyond, recognizing that there is a sense of urgency given the rapidly approaching deadline for submitting bids for 2020 Medicare Advantage offerings.

As we move forward in 2019, the evolution of health care and technology is progressing rapidly as evident by the government's implementation of Blue Button 2.0 and the large entrance of large companies like Google and Amazon in the health care space. Blue Button 2.0 puts the entire health record of a Medicare patient at their fingertips, giving them the power to determine who access to their information. This advancement facilitates the ability to integrate health care information and require companies like Humana to take action.

We will continue our momentum by executing and proving out the investments we made in our consumer-focused health strategy and expanding those investments to create a health ecosystem, deepening our health relationships in the 5 areas of focus I discussed previously.

In that context, we are placing additional effort and resources in the following areas: building the infrastructure to facilitate internal and external interoperability, including systems that create a longitudinal health record of a member or patient; developing an enterprise clinical operating model to integrate clinical interventions across health care channels; expanding the computing power of our data infrastructure, enabling us to increase our use of AI and machine learning, including partnering with leading external organizations; and developing more agile consumer experience development tools to create a simpler experience for our members and provider partners.

These efforts will accelerate our ability to identify the most important clinical interventions while also enabling us to personalize the experience. Combined, we believe these actions will drive higher clinical engagement. In addition, as technology becomes more sophisticated and the use of it expands, this will allow for more convenient access to care, like telehealth and home care. This will reduce the need for members to receive care in traditional settings like doctors' offices.

We're also refining our products to offer a more personalized experience based on customer segmentations to address members' functional and emotional needs. Although we have work to do, we are proud that Humana was recognized by Newsweek as Best in Customer Service among health insurance companies in the magazine's America's Best Customer Service 2019 rankings.

In closing, we are excited about our opportunity to improve the lives of millions of people we serve, while helping lead the way in transforming the future of our industry. Our success in 2018, coupled with our strong MA growth in the recently completed AEP, provided momentum into 2019. And today, we announced initial guidance of $17 to $17.50 EPS on an adjusted basis for the full year. This represents an increase of 17% to 20% over adjusted EPS of $14.55 for 2018. In addition, our Board of Directors has voted to raise our cash dividend to $0.55 per share, an increase of 10% from the company's previous dividend of $0.50 per share.

Brian will go into more detail in his remarks. With that, I'll turn the call over to Brian.

Brian Andrew Kane - *Humana Inc. - CFO*

Thank you, Bruce, and good morning, everyone. Today, we reported adjusted EPS of $2.65 for the fourth quarter of 2018 and $14.55 for the full year, ahead of our previous expectations. This represents adjusted EPS growth of over 20% for the full year, fueled by continued strong Medicare Advantage results, which we believe positions us well for a strong 2019.

Before I begin a more detailed discussion of our expectations for 2019, I will briefly discuss the fourth quarter and full year 2018 results. I echo Bruce's sentiment that our success in 2018 reflects not only the impact of our integrated care delivery model and the advancement of our strategy, but also the strength of our core operations. And we are pleased that our strong performance has translated to value for both our shareholders and our associates. As Bruce indicated, associates across all segments of the organization will benefit from the 2018 outperformance with higher-than-anticipated incentive compensation under the previously announced expanded program.

Turning now to segment results. Our Retail segment, led by our Medicare Advantage business, once again outperformed expectations, allowing us to finish 2018 above our previously anticipated pretax range. This strong result reflected an MA benefit ratio that was better than our expectations as inpatient medical trend and per member per month revenue consistently outperformed throughout the year.

Our Medicaid business also performed well. And notably, we secured a significant contract award to offer comprehensive Medicaid coverage statewide in Florida. We began providing services under the new contract in December 2018 and continue to phase in regions until the contract was fully implemented on February 1.

In the Group and Specialty segment, our TRICARE business finished the year strong and our ASO-level-funded product continued to gain traction in the marketplace. The migration from community-weighted to risk-weighted ASO products, particularly among healthier groups, while positive for the business going forward, did impact the medical benefit ratio. This slightly higher benefit ratio for the year, combined with the previously described increase in incentive compensation costs, resulted in full year 2018 pretax performance at the lower end of our guidance range.

Turning to Healthcare Services. Our full year 2018 adjusted EBITDA ended a bit below our previous guidance range, primarily reflecting transitory costs and investments associated with the integration of the acquired MCCI assets into the Conviva business, as well as the previously described increase in incentive compensation resulting from the strong performance by the company.

In addition, Kindred at Home incurred higher-than-anticipated costs in the quarter, including investments related to enhancing the capabilities of existing branches that present a substantial opportunity to service Humana membership, costs resulting from the shutdown of unprofitable branches and other costs incurred to establish an independent company.

Not only was 2018 a strong earnings year, but we also efficiently deployed our capital to significantly advance our strategy. As noted previously, we made investments in the home, completing the acquisition of a 40% stake in the country's largest home health and hospice operator, Kindred at Home, with an option to acquire 100% of the business in the next few years. We also made important investments in our primary care business and other clinical capabilities, and we successfully achieved the full exit of our noncore long-term care business.

Additionally, we returned meaningful capital to shareholders in the form of increased shareholder dividends and significant share repurchase. In 2018, we increased our per share dividend by 25% and repurchased shares worth approximately $1.1 billion, including the accelerated share repurchase agreement, or ASR, that we entered into in November of 2018.

I will pivot now to 2019 guidance. Consistent with our remarks last quarter, we expect 2019 adjusted EPS in the range of $17 to $17.50, an increase of 17% to 20% over our 2018 adjusted EPS and the second consecutive year of adjusted EPS growth in excess of our long-term target of 11% to 15%. This reflects top line growth above 11%, with 2019 consolidated revenues projected to be north of $63 billion, primarily reflecting strong Medicare Advantage membership growth and the Medicaid expansion in Florida.

2019 EPS also reflects the impact of a reduced share count as a result of the $750 million ASR entered into in November as well as a lower tax rate due to the health insurer fee moratorium for 2019. Additionally, we expect first quarter earnings to approach 25% of full year 2019 adjusted EPS.

I will now provide some additional 2019 color on each of our business segments that aligns with the waterfall slide that is posted on our Investor Relations website. In our Retail segment, as a result of a very strong annual election period, our January 2019 individual MA membership increased by more than 340,000 members, and we continue to expect full year growth of 375,000 to 400,000 members.

We are pleased that the health insurance fee moratorium for 2019 allowed us, and the industry as a whole, to make significant investments in products to benefit members and drive improved health outcomes. Given the investment in member benefits, we are expecting a higher benefit ratio in 2019 relative to 2018 and are guiding to a ratio in the range of 86.6% to 87.6% for the Retail segment, which at the midpoint is approximately 200 basis points above 2018.

It is important to remember that new Humana members are typically breakeven in the first year as it takes time to get them into our clinical programs and accurately document it from a risk reward perspective. Accordingly, while we continue to expect a reasonable pretax margin percentage improvement in 2019, given that we were meaningfully below our target in 2018, that improvement will not be quite as high as previously anticipated due to the higher-than-expected membership growth, which increases revenue while not impacting profitability.

It is also important to note, consistent with our prior remarks, while we expect 2019 to be below our long-term individual MA margin target, that target remains 4.5% to 5%. And we are committed to returning to that target margin over a reasonable period of time as we balance margin and membership growth, providing a significant source of earnings power in the years ahead.

Touching on Group MA, we continue to expect an increase of approximately 30,000 members in 2019. It is important to note that this growth is primarily driven by smaller group accounts where we have a very strong competitive position and value proposition. These small group accounts have historically performed well for us, and we expect that trend to continue in 2019.

From a Medicare stand-alone Part D perspective, or PDP, we continue to expect a membership decline of 700,000 to 750,000 members as a result of the deterioration of our competitive position given that we are no longer the low-price plan in any markets. This will, of course, impact our PDP insurance earnings for 2019. However, the PDP membership declines will have a more meaningful negative impact on our Pharmacy business and our Healthcare Services segment, as I will discuss in a moment.

It is important to remember that Humana was a first mover in the PDP space with a co-branded Walmart low-price plan, and Humana is committed to innovating around the value proposition in the years ahead to serve this market. I would also note, while the membership losses are not insignificant and we are committed to remaining disciplined around pricing, we continue to serve 4.5 million PDP members as of January 2019.

Finally, our Medicaid business is expected to grow 120,000 to 140,000 members as a result of the statewide award of a comprehensive Medicaid contract in Florida. This is expected to increase Medicaid revenue by approximately $500 million in 2019 as all the regions were fully phased in by February 1, 2019.

In summary, we are guiding to Retail segment pretax income in the range of $1.875 billion to $2.075 billion for 2019, an increase of 14% over 2018 at the midpoint of the range.

Moving to our Group and Specialty segment. We are expecting total commercial Medicare membership, including both fully insured and ASO products, to decline by 80,000 to 100,000 members, primarily reflecting the loss of certain large group accounts due to the competitive environment. Our focus continues to be in the small group space, particularly groups with 2 to 1,000 members, where we're able to offer more competitive plans and cross-sell our specialty dental and vision products.

We also expect to see a reduction in our fully insured 2 to 50 community-rated block that will be more than offset by growth in our level-funded ASO products which serve this segment. We continue to expect core trend to around 6%, plus or minus 50 basis points, generally consistent with what we experienced in 2018.

From a profitability perspective, we expect the commercial business to show nice pretax growth in part because of the HIF moratorium, but this will be more than offset by the previously discussed and anticipated lower TRICARE profits. Recall that TRICARE received positive final settlements in 2018 associated with the previous TRICARE contract that was replaced with the expanded East region contract with revised terms. All in, we are guiding to a pretax range of $300 million to $350 million for this segment.

For our Healthcare Services segment, we now expect adjusted EBITDA in the range of $1 billion to $1.05 billion for 2019, a bit lower than what we've been anticipating. This is primarily the result of the higher-than-expected PDP losses discussed above, the impact of which is exacerbated by the fact that the higher losses stem from our Walmart plan, which is greater-than-average mail order use rates.

Our adjusted EBITDA guidance for 2019 also reflects the cost of additional investments that Kindred at Home is making to enhance the clinical model in preparation for the Patient-Driven Groupings Model, or PDGM, including the implementation of the HomeBase HomeCare system across both the home and hospice platforms that Bruce discussed in his remarks.

From an operating cost ratio perspective, we are guiding to a consolidated operating cost ratio in the range of 10.6% to 11.4% for 2019, a significant decline from 13.3% in 2018, primarily due to the 2019 HIF moratorium. This ratio also reflects lower projected annual incentive compensation costs year-over-year given the 2018 outperformance, as well as productivity gains, partially offset by investments in technology and clinical capabilities.

I would like to now briefly discuss capital deployment for 2019. We recognize the importance of returning capital to shareholders, and our 2019 guidance reflects the impact of a $750 million ASR that we entered into in November '18 as previously discussed. Given the size of the ASR and our desire to maintain strategic flexibility, no additional share repurchases are assumed in our guidance. In addition, as Bruce discussed, today, we announced that our Board of Directors increased our cash dividend by 10% to $0.55 per share, representing the third consecutive year with a meaningful per share dividend increase.

From an M&A perspective, we continue to evaluate strategic acquisitions to build our -- built out our capabilities, particularly in the primary care arena, where we generally look for companies that could enhance our Healthcare Services segment, including opportunities associated with technology, specialty pharmacy and other clinical assets.

Additionally, we would also have interest in health plan assets that increase our presence in underpenetrated markets. As I've said previously, we targeted -- we target a total debt-to-capitalization ratio of approximately 35%, consistent with rating agency expectations with the ability to go higher for the right strategic opportunity.

Finally, I want to remind everyone that we plan to host an Investor Day on March 19, 2019, in New York City. Please save the date.

With that, we will open the lines up for your questions. (Operator Instructions) Operator, please introduce the first caller.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Josh Raskin from Nephron Research.

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

I guess my question is just around the Retail segment MLR, you mentioned up 200 basis points on a year-over-year basis. So I guess the question is, how much of that is the HIF moratorium and how much of that is sort of benefit additions and growth? I just kind of juxtapose that with your growing faster than the market, but your MLR is going up a little bit more. And so I'm just trying to figure out sort of the sustainability and what if the HIF does come back as planned in 2020, how much of that benefit addition has to get rolled back?

Brian Andrew Kane - *Humana Inc. - CFO*

Josh, it's Brian. So as I mentioned, we did have a higher year-over-year MBR (sic) [MLR] by about 200 basis points. The HIF is broadly in that range, plus or minus. We looked at the whole host of funding elements that we had. The HIF moratorium was one of those. Obviously, the rate environment was very positive for the sector. We still had some benefits from tax reform. We have the tax benefits of the HIF moratorium. So all those really went into our calculus as we tried to strike the right balance between benefit enhancement to drive growth as well as margin enhancement to drive earnings. And I think we struck a nice balance there. Obviously, we're mindful that the HIF could return in 2020. We are planning for that, both with respect to the cost in the organization as well as the return on investments that we anticipate getting from our trend bender investments. And I would just say I think we've been prudent and thoughtful about the potential of the return of the HIF in 2020.

Operator

And your next question comes from the line of Ana Gupte from SVB Leerink.

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

I wanted to follow up on your commentary about disrupting the Part D market and how that plays into the changes that are being suggested on rebates and the impact on Part D pricing. I guess, the question is, firstly, are you on board, and do you think this will happen for 2020? And then secondly, how does that offer you an opportunity potentially to be disruptive? You do have a gap to PBM and the bundled MA PD product.

Brian Andrew Kane - *Humana Inc. - CFO*

Ana, without commenting too much on the specific of the rebate proposal, obviously, that would be a major change in the way the PDP and PD program works if rebates or discounts were to go point of sale. Our perspective is that, that would raise premiums for the broader populations. And that in of itself, I think, creates some disruption in the marketplace that we have to think through. I think broadly, what we're thinking about when we talk about sort of creating a different value prop is irrespective of where rebates go, and it's just something that we're thinking about with -- obviously, with our potential partners as well. And I wouldn't want to comment beyond that.

But the rebate change is material, and it's hard to say whether it will be implemented in 2020 or after that. One of the things we're mindful of is the potential adverse selection it could have on the way the product is priced given the fact that the idea of negotiating the best rebates could create a risk pool that is imbalanced. And so the question of what kind of incentive that creates for PBMs to negotiate those discounts is something that I think the industry and policymakers need to think through. But wherever policy goes, we're prepared for it, and we feel good about just broadly how we're positioned.

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

I would just add to what Brian is saying. And as a -- I think the Part D market is in an evolution as a result of policy rebates at the -- counter is one example of that, but also some of the innovative programs that are coming out of CMMI. We won't give you details of how we're going to construct it, but we do believe that, combined with -- as we study the market, there are certain needs that are maybe a little broader than just Part D needs from a pricing point of view, and you can package some other services within that. And so we see this -- there's a time here where I think the market has run its course, has commoditized, and these changes actually offer a refreshing for the value proposition that's out there. We want to use these changes as actually a way to enhance the value proposition outside of just running the price down.

Operator

And your next question comes from the line of Kevin Fischbeck from Bank of America Merrill Lynch.

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

Wanted to see if I could ask 2 questions. I think that they're the same question. On your bridge, on the guidance, it has a line there for HIF flowing through with -- I guess, partially offset by some tax issues, which is adding about $1.51 to EPS. If we -- if that's the case and we exclude that, then your core is now growing 8%, which would be below your kind of long-term guidance. So wanted to understand that. And I guess, secondly, and I think this might be part of the answer, but I'm not sure. It wasn't clear to me exactly what that other column was related to in that chart. I understand interest expense being higher, but I wasn't sure what else was in there.

Brian Andrew Kane - *Humana Inc. - CFO*

Well, let me show the other. The other is simply -- there's a whole host of things in there, but including the sort of adjustments from EBITDA to pretax in our HCS segment, that's an important element. So there's a bunch of changes going on in there. There's some increase in interest expense and other things there. So it's almost obviously a catchall category, but there's nothing really to spike out there beyond what's in the footnote. But I think...

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

Your services EPS number is just the EBITDA impact converted to EPS, and then the other have the below-the-line items. So you kind of net those 2 things to kind of say what the actual EPS benefit looks like.

Brian Andrew Kane - *Humana Inc. - CFO*

Well, but there's other things in the other besides Healthcare Services changes, but an important element is the Healthcare Services changes. Again, we believe the business, and we focus on it as a company internally, should really be an EBITDA-type business. And so there are whole host of changes below the line. Recall that as a 40% owner in a highly leveraged business in Kindred, there's a lot of debt impacts there that get consolidated below the EBITDA line. And when we build out our clinic business, that drives incremental depreciation that doesn't necessarily reflect the earnings power of the business. So there are host of things that are going on in that other line, but we thought -- which is why we changed it in 2018. We thought focusing the investors on EBITDA was, frankly, the right way to think about the business. And also frankly, if you think about the way assets trade in the private market in these types of businesses, they trade on an EBITDA basis. So that was where the genesis of that.

With respect to your first question on pretax growth effectively, it is, I would say, obviously below -- slightly below the 10%. But this year was a bit of an anomaly because of the tax changes, and so as we've said in multiple contexts, we really thought about the benefit/margin trade-off holistically. And so as I said in my remarks, we have a nicely increased pretax margin in the business. It's not getting to our pretax range, but there's a lot of below-the-line benefits as well. And then ultimately, we're focused on driving EPS growth in our 11% to 15% range, which, this year, as we've mentioned, and last year, 2 years above that range. And then we're focused on, obviously, driving top line membership. So that's sort of the balance that we try to strike.

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

And I would just add to Brian that the challenge -- and we apologize to the investors. The confusion is really around what's pretax and what's post-tax. And our approach as a business in looking at returns, we're looking at after tax. And it's hard for you to look at a pretax margin, pretax growth, core growth when these tax items are being incorporated in pricing structure, how we look at our overhead and other things as a result of some of the changes that both happened in tax reform and in the HIF. So I -- it is complicated for you to just pick one line item there, and we apologize for that.

Operator

And your next question comes from the line of Steven Valiquette from Barclays.

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

I think the margin questions you just touched on, so maybe just shifting gears here a little bit. Just looking for maybe some comments on the HHS proposal on the drug rebates from last week. My sense is it probably would not hurt your profitability that much because you and really every Part D plan sponsor could raise premiums to offset that. But just any extra color around your thoughts about that proposal would be helpful.

Brian Andrew Kane - *Humana Inc. - CFO*

Yes. And I tried to address this in a previous question. I think the rebate proposal is something that, obviously, we continue to study, the industry continues to study. To the extent it goes through, obviously, the hydraulics of the way the supply chain works has to change because rebates are no longer flowing through the PBMs, they're going to have to flow through the supply chain differently, and so all the contracting is going to have to change there. Again, I think the bigger issue is more around the impact on the customer, the broad customer who's going to see a premium increase and a meaningful one, and CMS acknowledged this. Pharma should benefit from this. The government's going to pay more from this because the direct subsidy is going to go up. And so there's a whole host of complexity that has to be worked through.

I think once all that is sorted through, again, just to come back to the bigger issue, I think is around adverse selection and what that does for the incentives for people to negotiate good discounts for their members more broadly. So it is going to be -- it will have a meaningful impact. The timing of which is still uncertain, and that's something we need to understand better. And I imagine, as we all comment in the next 60 days, there'll be a number of additional pronouncements that are made here.

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

Just a few additional comments, knowing that this is something top of mind for our investors. As a company, we completely support what the administration is trying to do, is to continue to lower the drug costs. We believe that's the right thing to do and always. This particular program is going to reduce drug costs for a particular sector of the population, the individuals that are buying it, but it will raise the cost of drugs through insurance and the other parts. And that's sort of where just -- we're moving dollars around from one party to the next.

The transition is something, as Brian is articulating through, that there is -- we have to work through about what the administration and understanding that, and our response and the filing of the letter will bring that out. And also the drug companies, because there's a lot of work that has to happen on both parties on how you get the discounts, how you have to redo the contracts, the processing that takes place at the counter and all those things. So it is a -- it is not an easy transition that needs to be happening, and we will provide the complete details as we understand them and the transitioning there. But there are moving parts, contracts and the timing of those contract changes and how do they ensure that they are in the Part D bid process. Because if you change it after the Part D, then your prices are different and you have to manage through that. And then secondarily, how do you manage through the processing part that happens there. So stay tuned. We are -- we obviously will support the administration if this is the final ruling, but it does have a lot of complexity to it.

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

In Part D, there are some public companies posting MLRs that are surprisingly low, giving us a sense, in Washington, the Part D plan sponsors are just too profitable and that's part of the focus here. Do you think that's not really the focus? Just curious on that extra nugget.

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

I'll add to that. I mean, I -- we are amazed that some of the MLRs that are out there that have been publicly described there because we have done a lot of work with our drug cost and we are -- in a very competitive fashion there. So there is pricing there that maybe has other things versus just the drug cost and the maybe wanting to gain more market share. So that's one area. I would say that within the industry of Medicare Part D, because of the way the bids are processed and because of the way that our rebates are fully disclosed in that bid process, it is very transparent in the margins that you see that all rebates are incorporated in the Part D pricing. So the -- unlike the commercial where it's much different in the transparency, because of the regulations and the oversight of Part D, you have full transparency of both pricing at the counter and the rebates. And so it's not because there's excess profits in Medicare Advantage or Medicare Part D, it's really getting more transparency at the counter of what the cost is and really sharing the rebates back to the people that are buying the drug versus sharing it across the general population. And that's just the policy change. That's really no more than that, that has not taken -- it's not taken dollars out of the system, it's just reallocating the dollars because the dollars are already allocated to the system.

Operator

And your next question comes from the line of Peter Costa from Wells Fargo.

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

Your guide of $17 to $17.50 seems pretty much in line with the guide that you talked about on the third quarter call. There's been some changes in terms of the performance of your business in terms of -- you even mentioned Healthcare Services business performance will be a little worse than you originally thought because of the lower Part D membership. The retroactive rate adjustments on the group business seems like that's a little bit more negative and perhaps carries into next year. And then you had more MA membership, but you talked about that not having as much of an impact on the earnings line, but a bigger impact on revenues. So you've outlined a few negatives relative to the third quarter, were there some positives in there? Perhaps maybe the fact that 44% of that -- I think that was of the number, of the MA business came from competitors and makes that cohort a little bit more profitable? Is that what makes the guidance the same?

Brian Andrew Kane - *Humana Inc. - CFO*

Peter, it's Brian. I think it's fair to say that our Retail MA business is improved versus where we were, I guess, in the third quarter call. And that, as you mentioned, offset by some of those negatives. So that's how we get back to the $17 to $17.50. I think we feel very good about how our Retail -- I should say, our Retail MA business is trending. And so I think that's a fair commentary.

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

So it's...

Brian Andrew Kane - *Humana Inc. - CFO*

Again, I'd -- but I'd focus on the HCS, less on the group side. Just to be clear, the 300 to 350 is well within our expectations of the performance there, which is better commercial earnings, lower TRICARE earnings. It's really the offset of HCS and Retail. And these are slight numbers, these aren't material one way or the other.

Operator

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

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

Brian, you said that you're not -- your margins in individual MA are below that 4.5% to 5% target. If I just look at the trajectory in what you've shared before, I'm getting to a number that implied in guidance that might just be below 4%. Is that in the right ballpark? And then looking out to 2020, any kind of early thoughts on the rate release and their ability to improve margins should they come back next year?

Brian Andrew Kane - *Humana Inc. - CFO*

Yes, Justin. Again, I'm just always hesitant to give point estimates on the margin. I think it's fair to say that we were significantly below our margin target in 2018. And I think significant -- as we've said before, has certainly three handle next to it and towards the low end of that range. And I would just say we've improved that nicely for 2019, but still below where we want to be for the 4.5% to 5%. I think it's too early to give 2020 guidance. We'll see where the rate notice finishes up, and we still have a ways to go to get the final notice. Obviously, the HIF is a really important element here as well, and that's something that we're all waiting on. Regardless of what happens, we're committed to growing this enterprise, and I think you'll see that. I just am hesitant to give any specifics for 2020 at this point.

Operator

And your next question comes from the line of Dave Windley from Jefferies.

David Howard Windley - *Jefferies LLC, Research Division - Equity Analyst*

I have a couple of -- a 2-parter around the ACA court case. The more relevant of those is, does that pending decision influence your appetite for Medicaid as you stand here today? Does that cause you to kind of move to the back burner and wait to see that outcome? And then two, if it were -- if it really were to be upheld, clearly, there's HIF implications, but there's also trend to parity rate implications. And I'm wondering, in that instance, would you think about -- would you expect to see rates ratchet back up?

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

I'll try to answer that in reverse order. I can't comment on the reversal of the rates. I think that's too speculative on what would happen in -- with CMS or would there be other policy interventions there to fix that. So that's something I'd rather not comment on. I can comment on our appetite, as you put it, for Medicaid and where our view is on that. We continue to believe our capabilities of the -- of being able to service complex individuals, both from their lifestyle and, in addition, from their health care as a strength that we have and has been demonstrated for years. And the Medicaid dual population is a population that we serve today quite effectively, and we will serve tomorrow quite effectively. And feel that, that is a market that we should continue to grow in and be successful in, in offering a very strong value proposition to the states.

So as we think about the changes with the court case or potential changes, that doesn't change our belief that we continue down the road of the Medicaid population. It will be catered to different states, whether they have expansion or not, whether they are going out with a program that is going to be more oriented to duals and less oriented to SNFs. And so I would say our appetite continues to be very strong for Medicaid, but specifically focused on the dual population, but will serve other populations as the states both require and their preferences would be.

Operator

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

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

I just wanted to ask about -- go back to that comment of 44% of the lives you've picked up have come from competitors. I wonder if you could give us some perspective on that. Is that consistent with what you've seen over the years? If it's may be higher than usual, does it suggest other people -- is the competitive landscape somehow changing, particularly with what's going on with the HIF? And if it's -- does it say anything about your expectation around the underlying growth of MA this year if 44% are coming from others not new and agents?

Brian Andrew Kane - *Humana Inc. - CFO*

Yes, A.J., I would say it's slightly above the last few years, but not -- I would not call it a material difference from where we've been. I think there's been some commentary -- I'm glad you asked about the growth of the MA market this year. And if you look at January over January on the CMS tape, it seems a little bit lower. But actually, the right way to look at this is to pull out the Minnesota cost plans because there was a big conversion there where they were no longer offered. And so some of those members went to MedSup, and a number of those went to Medicare Advantage. So it was actually a big opportunity for the sector to get those members into MA. But the way it's counted from an industry perspective, the cost plans are actually in the growth rate. So it distorts it. If you pull that out, actually, you'll see that actually the market is growing faster than last year. And we are taking a disproportionate share of that faster-growing market.

So I -- we feel very good about how we're positioned. We feel good about how we priced. And obviously, it's still early where we are. It's only early February, but there's nothing that we've seen, as Bruce indicated in his remarks, that gives us any pause about the numbers that we've put out today. And so all in all, we're very bullish on our Retail segment, on our Medicare Advantage growth potential, both in terms of top line and bottom line.

Operator

Your next question comes from the line of Sarah James of Piper Jeffrey.

Sarah Elizabeth James - *Piper Jaffray Companies, Research Division - Senior Research Analyst*

Humana has recently talked about how some Part D bidders may perhaps be pricing with levers in mind that Humana doesn't have, and I think this could be referring to revenue synergies from retail locations. So if pricing considerations is beyond the product itself, what can Humana do to compete? And specifically, what other services are you talking about packaging together with Part D to drive value creation? And is this packaging a shift in strategy to targeting a more benefit-rich segment instead of your traditional low-price-point segment?

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

Yes, I don't think we'll comment a lot on what services we'll add. I would just say in general what we see, and this happens in a lot of different industries, that you're seeing a commoditization of a product, and you have to come out and enhance the value in other ways and segment it accordingly. I just think that this is evolution of the industry. That sort of is mashed with policy changes that are happening too. And I think the combination of those 2 things offers an opportunity or, for that matter, could be a negative for some companies. We have mentioned then at times that some companies have revenue synergies as a result of the retail front end, and -- but we also have the mail order synergies in the back end. And when we see this year of who is taking share, it's really someone that doesn't have significant synergies, doesn't have either one of them. And we look at it and say, "Well, that's interesting. It seems to be more of a price game than a competitive advantage one way or the other."

So I just would emphasize to the investors that Part D is still a very large commitment by us, as you can see from the way we've approached, both in our Medicare Advantage and in this particular Part D business is that we are very oriented to delivering value at a price that we can earn a return. We're not going to buy market share. You don't see us doing that in Medicaid -- Medicare, you don't see us doing that in Medicaid, and we're not going to do it in Part D. We feel that our brand, our service, our expectations in meeting our customer, along with enhancing the value through our ability to impact clinical outcomes, is the strength we have and we shouldn't cheapen that strength. So stay tuned. I think there's an opportunity in the marketplace to be disruptive as all these changes. We're obviously not making promises here, but we do believe that the market is in need for changes and we believe the environment is presenting some opportunities there.

Operator

And your next question comes from the line of Scott Fidel of Stephens.

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

Just had a question just on the Group segment in commercial and just some of the trends you saw in the fourth quarter. Just in particular around the mix shift that you're seeing into the level-funded ASO products and small group. Do you have any projection on what you're expecting in terms of the mix shift in 2019 relative to 2018? I know you're like at 26% at the end of the year. And then also, just talk about how you're pricing sort of the residual commercial risk book just given some of the, I guess, sort of marginal adverse selection issues that seem to be showing up as part of that mix shift.

Brian Andrew Kane - *Humana Inc. - CFO*

So you just pointed to it. If you look at our press release, you can actually see the percentage of members in ASO continuing to tick up. Just to give you some context, in 2018, we saw about a, call it, 50,000-, 55,000-member increase in that level-funded product and a commensurate decrease in the 2 to 50 community-rated product. I think you're going to see even more of that in 2019. So even a more disproportionate share. It's something that we are targeting. And so if you think about our block on the 2 to 50, you have the ASO-level funded, which is a business we really like because it's effectively risk-rated, the customers like it, it's customized to their needs and it's the right risk profile. You have the transitional relief business that's still out there. These so-called grandmother products from the ACA. That's a business that performs quite well for us. And then you have this small group, community-rated 2 to 50 product, that has been more challenging.

One of the issues you have in that business also is estimating what your risk adjustment is going to be and how that's going to effectively play between your book and other books. But it's not as nearly a stable market as we'd like it to see, and we are seeing that shift, that healthier blocks who can get under it and are going to go to this ASO-level-funded product, which basically gives them a stop-loss protection that -- so they're protected for any significant health care costs. But effectively, it allows them to be self-funded and they get the best of both worlds. So without giving a prediction on the percentages, I think you'll see a continued shift there. We think that's a positive. We're actually, I think, optimistic about where the group business is headed and the opportunities we have to disrupt that marketplace. One of the benefits of not being a major player in the group business is that we have more opportunity and more flexibility to try different things. And so I think you'll see us do that in a very prudent way.

The other element of this business, which is really important that we don't talk a lot about, is our TRICARE business. I mean, we have 6 million military members. They like us a lot. We have a great relationship with the U.S. government. They're moving more towards perhaps some value-based experiments there and some elements of risk. It's something that we're working closely with our Department of Defense partners on, and we're also very excited about that business. So more to come on that. But the fourth quarter had some of that migration that you mentioned. There was also some settlements that we basically put behind us just to set us up for a strong future. And so that's really the story there.

Operator

Your next question comes from the line of Ralph Giacobbe from Citi.

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

I did want to go back to the Retail margin guidance. I certainly understand you're growing enrollment faster, but typically, you do consider sort of high single-digit growth as some baseline. So the incremental 300 to 400 basis points in growth, even at 0% on your pretty big base and then considering the improvement in margin from those coming on from prior years, just doesn't seem like it would have the magnitude of impact that you're suggesting. And on top of that, we have the better rate backdrop and the HIF moratorium. So just curious on whether there is something else, if it really is just conservatism. And to your comments, Brian, about being sort of prudent and thoughtful, just given the potential comeback of HIF, should we take that to mean at least margin preservation in 2020.

Brian Andrew Kane - *Humana Inc. - CFO*

Sure. Look, our intent is not to decline -- to degrade margins in 2020. I think that's fair to say. But obviously, we have to understand the rate environment where the HIF goes. But as we've said, we've committed to continue to improve the business and to grow the business and to grow top and bottom line. And that's regardless of where we are unless, obviously, there's a very unexpected situation with regards to the rates. But we are committed to growing this business as I've said.

On the 2019 side, I wouldn't underestimate the impact of several billion dollars of incremental revenue. It's not an insignificant amount, but I think it's fair to say, and just going back to Peter's question, that we feel good about where our Retail business is positioned. And we have seen and we will see, in 2019, a nice improvement in the pretax margin. The actual individual MA pretax growth is meaningfully above the overall enterprise pretax growth given some of the other moving pieces. So I think you are seeing really nice pretax growth on the individual MA side. So again, I think we feel good broadly about where we're positioned on the Retail side here.

Operator

Your next question comes from the line of Steve Tanal from Goldman Sachs.

Stephen Vartan Tanal - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

I guess one just on the Healthcare Services segment and the outlook. I'm just trying to get a little more color on how Part D flows through. Can you sort of talk about the sources of profit that the segment made some captive Part D plans other than mail order, if any, and how the enrollment decline kind of flows through that segment. Sort of thinking about the outlook as well and maybe if you could dig into kind of the flat to down adjusted EBITDA guidance for the services segment, maybe break that down a little bit into sort of the PBM profit decline related to Med D versus lapping some of the investments that you framed in '18.

Brian Andrew Kane - *Humana Inc. - CFO*

Sure. Well, first of all, the adjusted EBITDA guidance is up. It's not down, just to be clear, if you look at year-over-year. And so it's just -- it's been impacted by some of the PDP changes that we've had with regard to membership, which was a little bit worse than we had anticipated. That flows through both on the PBM side as well as the mail order side. The bigger impact is on mail order. As I mentioned, the Walmart plan has a high -- relatively high mail order penetration. So when we lose those members, you're going to have an impact on Healthcare Services. But we're still growing EBITDA nicely in the sector if you look at year-over-year, where we finished and where our guide of $1 billion to $1.050 billion suggest where we'll be.

So again, PDP is an important element of HCS. It's just one element. Obviously, MA is an important part of that. The nice part about MA is we're growing above our expectations, so that's helping to offset some of that PDP pressure. An important element of Healthcare Services also is Kindred, and it's important that we invest in Kindred for the long term. And so for example, implementing HomeCare HomeBase, while an expense for 2019, it's a decision that the Kindred board made recently because we thought it would position us better for the future and enable us, as Humana, to attain the clinical outcomes and the clinical measures that we're striving to do. So we thought that was a smart investment to make.

And also importantly in the segment is our primary care business. And so we have the Conviva business that we're continuing to focus on, on the turnaround there, where we've been impacted over the last few years by a difficult rate notice. The rate notice was better for 2019, but there's still a whole host of operational improvements that the team is making and committed to making. And then we're also investing in additional primary care assets in the Healthcare Services segment where we continue to put down our own clinics as well as work with our JV partners to put down clinics, and that has some impact on the profitability as well. So again, I think we feel good about HCS, and we think about it holistically with our Retail business.

Stephen Vartan Tanal - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Maybe just one quick follow-up then. Just on the sort of pretax investments that were associated with tax reform. How were those treated in the '19 financial plan? I think there was $360 million in '18, about I think half of which was potentially not recurring, about half I think went into wages. Just curious on how that flows into the guidance, and then that's it for me.

Brian Andrew Kane - *Humana Inc. - CFO*

Sure. So you're right in the way you broke it out, $2 went to shareholders, $1 went to effectively higher wages and everyone benefiting from our -- or most people benefiting from our bonus program, which was a big change and exciting for a lot of our associates, and then the other dollar effectively in investments, both in the enterprise as well as the community. That all goes into the process as we went into 2019 and said one of the dollars that we have to invest -- and by investing, I mean, investing in benefits, investing in our business, so the clinical capabilities that we're developing and technology investments that Bruce referenced, and then, obviously, investing in margin. And so that all went back into the funding pot, I would say. The dollar to associates hasn't changed. That's still in our run rate, both the higher minimum wage as well as the bonuses. But the incremental dollar was just part of the whole funding pot that we had to grow -- to increase growth and margin in 2019.

Operator

And the next question comes from the line of Gary Taylor of JPMorgan.

Gary Paul Taylor - *JP Morgan Chase & Co, Research Division - Analyst*

I guess I'm going to revisit MLR guidance just for a moment, and I appreciate you've talked a lot about it. I guess from my perspective, if we think about the HIF being -- or a lot of the HIF being potentially invested in benefits, it could easily account for 200 basis points of MLR. And you talked about a few things that were impacting that guidance. But maybe specifically wondering, was there any underlying -- I can't talk today, I'm so sorry -- any underlying change in the trend guidance incorporated into that MLR outlook? Or is that stable?

And then secondly, maybe just 30 seconds, Brian, on -- it seems like your approach to investing the HIF in benefits in 2019 was pretty substantially different than the approach you took in '17, where you held out a portion that was related to the tax benefit. You grew substantially slower than the market this year. You -- it sounds like you're putting a lot of the HIF into benefits and obviously are growing faster than the market. So 2 things. One, any underlying change in trends. And just two, just give us a refresher on why you decided to take the different approach heading into the 2019 holiday.

Brian Andrew Kane - *Humana Inc. - CFO*

Sure. So with respect to trend, no change. Obviously, we reflect what our perspective of trend is going to be for 2019. We're always, I think, very prudent about the trend we put into our bids and ensure that provisions for any adverse deviation, as we call it in actuarial speak, is accounted for. And so we're very mindful of that. And I think we've been prudent about the trend we put into our bid. So I don't think that necessarily changes year-over-year. With regard to the HIF, again, I wouldn't necessarily characterize it as a difference. The difference really in '17 was an accounting question. Because there was a question whether it would come back or not, we just decided to exclude it, the tax impact from our guidance, just to create some comparability for investors. The fact that it went away again, in 2019, made that option not possible.

If you look at our waterfall, you can see that we've called out specifically the HIF tax impact. We said $1.79, less a few other just tax changes that we've had year-over-year and a few other things there. But we've been very clear that we've called that out. So in some respects, we really haven't treated it differently. I mean, we're getting the tax impact of the HIF into our numbers. The other, obviously, difference between '17 and 2019, the rate environment was also very different. And so that is something to think about. And so I think 2019 helped us there as well in terms of the MER impact and the ability to invest in the like and the impact that, that flows through on MER. But in summary, no change in trend. Our philosophy hasn't changed. And on the HIF, I think, really, the change hasn't been dramatic from what we thought it would be in -- or what we -- how we priced for it in 2017. It just shows that differently from an accounting perspective.

Operator

And there are no further questions at this time. Mr. Bruce Broussard, you may continue.

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

Okay. Well, great. Well, I will just close it out by first saying thank you to all our associates, the 55,000 people that really make this happen, and especially then taking care of our members and our provider partners. And at the same time, I thank the shareholders for their long-term support of the organization.

And as Brian mentioned, we are having our investor meeting in March 19 in New York City. And that's where the investors will be able to see more exposure to our strategy, and as importantly, the breadth of the management team that really helps make this -- make all this happen. So we hope to see you there. And again, thank you for your support.

Operator

Thank you, presenters, and thank you, ladies and gentlemen. This concludes today's conference call. We appreciate your participation. You may now disconnect. Have a good day.
