04-May-2021

CVS Health Corp. (CVS)

Q1 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, good morning and welcome to the CVS Health First Quarter 2021 Earnings Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow CVS Health's prepared remarks, at which point we will review instructions on how to ask your questions. As a reminder, today's conference is being recorded.

I would now like to turn the call over to Katie Durant, Senior Director of Investor Relations for CVS Health. Please go ahead.

Katherine K. Durant

Senior Director, Investor Relations, CVS Health Corp.

Thank you, and good morning, everyone. Welcome to the CVS Health first quarter 2021 earnings call. I am joined this morning by Karen Lynch, President and CEO, and Eva Boratto, Executive Vice President and CFO. Following our prepared remarks, we will host a question-and-answer session that will include Jon Roberts, Chief Operating Officer; Alan Lotvin, President, Pharmacy Services; Dan Finke, President, Health Care Benefits; and Neela Montgomery, President of Retail and Pharmacy. Our press release and a slide presentation have been posted to our website, along with our Form 10-Q that we filed with the SEC this morning.

During this call, we will make certain forward-looking statements, reflecting our current views related to our future financial performance, future events, industry and market conditions, as well as the expected consumer benefits of our products and services, and our financial projections. Our forward-looking statements are subject to significant risks and uncertainties that could cause actual results to differ materially from what may be indicated in them. We strongly encourage you to review the information in the reports we file with the SEC regarding these risks and uncertainties, in particular, those that are described in the cautionary statement concerning forward-looking statements and risk factors section in our most recent Annual Report on Form 10-K, this morning's earnings press release and included in our Form 10-Q.

During this call, we will use non-GAAP financial measures when talking about the company's performance and financial condition. In accordance with SEC regulations, you can find a reconciliation of these non-GAAP measures to the comparable GAAP measures in this morning's earnings press release and the reconciliation document posted on the Investor Relations portion of our website. Today's call is being broadcast on our website, where it will be archived for one year.

Now, I would like to turn the call over to Karen.

Karen S. Lynch

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

Good morning, everyone, and thank you for joining our call today. In what continues to be an unprecedented environment, CVS Health has delivered strong first quarter results. For all of us, the past year has been defined by the pandemic and our response to it. In the first quarter, CVS Health orchestrated an all-out effort to vaccinate Americans against COVID-19. I am proud to say we have helped achieve the President's accelerated 100-day goal of 200 million vaccines. This would not have been possible without the dedication and effort of our approximately 300,000 colleagues who worked tirelessly throughout the pandemic and delivered when they were needed the most.

Our results show we are providing superior value by creating an integrated health care model that is centered around the consumer. Our unparalleled capabilities, reach and relationship with customers uniquely positions us to support them throughout their lifetime. Our strong first quarter delivered revenue growth of 3.5%. We generated adjusted earnings per share of $2.04, up nearly 7% versus first quarter of 2020. As a result, today we are increasing our adjusted earnings per share guidance to $7.56 to $7.68 to reflect the momentum across our business. Importantly, our performance reflects both growth in new and current markets. Eva will provide more details on our outlook and our results.

Before turning to our three business segments, I'd like to underscore our ability to anticipate, deliver and exceed customers' healthcare expectations. Today, we will share where we are seeing momentum and highlight several important achievements. It is clear that consumers want convenience, transparency, choice and control over their healthcare. That is why we are engaging consumers in new and different ways by working to meet their health needs in the community, in the home and virtually.

Each of our businesses performed at or better than our expectations this quarter. We delivered strong results in the Health Care Benefits segment, fueled by continued growth in Government Services. During the first quarter, utilization approached near-normal baseline levels. We have continued momentum in our Government Services business. We increased membership across all Medicare business lines in the first quarter. We outperformed with dual-eligible members, delivering over 30% growth, and we significantly expanded our reach, adding 14 new states. Finally, as we announced last quarter, we will re-enter the Public Exchanges in 2022. We expect to enter up to eight states, where we believe we can make a meaningful impact and maximize returns with our first-ever Aetna-CVS branded offerings. We are committed to helping provide access to affordable care for all Americans.

We also achieved strong revenue and operating income growth in Pharmacy Services, building on the foundation of our specialty management capabilities and overall service excellence. As we announced last week, we delivered market-leading results in controlling drug costs for Commercial clients, with only a 2.9% overall drug trend, with 34% of clients experiencing negative trend in 2020. Specialty pharmacy revenue was up 7.2% year-over-year. This reflects new net wins due to our success in our trend management program, which continue to resonate in the marketplace and drive more customers into our channels. Specialty pharmacy spend management also remains a steady growth engine and key differentiator in the market. We are well positioned for continued growth in 2022.

Our Retail segment continues to play a vital role in the delivery, care and wellness. It's an integral part of our customer and community strategy. Since we began, we successfully administered over 23 million COVID tests and over 17 million vaccines through April. We are currently administering vaccines in 49 states and in more than 8,300 CVS locations. A one-third of vaccinations have been administered to members of underrepresented communities. Our strong second dose compliance of over 90% is the result of our consumer-centric digital approach. We schedule round-trip visits, booking both appointments at once, and we also provide appointments for second doses only.

We are successfully driving health services engagement among customers who are new to CVS Health through COVID testing and vaccines. This has helped somewhat offset the impact of a weak flu, cough and cold season. Although early, we have seen improvement in April, as vaccinated customers are more actively shopping in CVS locations, part of a nationwide trend. For those customers that are new to us through COVID testing, we have realized about a 9% conversion in filling a new prescription at CVS Pharmacy. We continue to attract consumers to our CarePass subscription program, with approximately 4.5 million members in total, up approximately 18% from 2020.

Building on the success of our employer and university programs, we recently expanded our Return Ready offering to include vaccinations. We've already administered 40,000 doses, and client interest in this new service is strong and growing. Overall, we have successfully navigated through a challenging retail environment, while capturing additional benefits from new customers we are bringing into CVS Health. As the nation's leading diversified health services company, we're advancing our technology and using CVS Health assets to connect consumers across the healthcare ecosystem.

We're addressing the most prevalent, costly and complex health conditions by expanding our platform to deliver more integrated care. Our approach combines both face-to-face and virtual points of care that are personalized to the individual. We prioritize the most valuable interventions, the next-best action a member can take that will lead to a positive impact on their health and on medical costs. For example, early results in our Transform Diabetes program show an 8% improvement in changing Medicare members' behaviors. This program is on track to exceed its projected medical cost savings and return on investment of 2-to-1. With approximately 1.5 million members having access to this program today, we expect to add an additional 1.3 million members this year.

Our new medical benefit plans are designed with low-copay or no-copay at MinuteClinics. We have approximately 7 million Aetna members enrolled, up from about 2 million members or 350% member growth year-over-year. These plans offer broad access to affordable and convenient care with many CVS Health assets. First quarter results show Aetna Commercial members are substantially more likely to use a MinuteClinic when enrolled in this type of plan, compared to those without the benefit. In fact, these members are approximately 50% more likely to visit a MinuteClinic for an acute medical need, immunization, or COVID test. We also expanded our HealthHUB offerings to include new services around behavioral health, an increasingly important component of care, especially during the pandemic. Our strategy is to deliver a single, integrated experience that connects individuals to a CVS Care team, virtually and face-to-face, by navigating consumers to the best site of care.

We are a company focused on delivering the most convenient, connected experiences for our customers across our CVS Health digital assets. Our ability to redefine the health experience in an increasingly digital and hybrid world, combined with our vast health assets and understanding of consumers' health, uniquely positions us for growth. There are three areas where I want to specifically highlight some of our achievements in the last quarter. They include using our digital assets to expand engagement with our members, expanding into new services and offerings, and leveraging digital capabilities to enhance the customer experience and improve our cost structure.

Starting with engagement, we saw more than 80% increase in visits to our flagship digital properties year-over-year. Growth was primarily driven by engagement in our expanded set of digital health services such as COVID testing, vaccinations and omni-channel pharmacy. Next, we are expanding access to care through our digital and virtual channels. We launched a digital-first primary care model that helps consumers navigate the best site of care for their health needs. And lastly, we are also harnessing technology such as AI, machine learning services and natural language processing to simplify our process and optimize our cost structure. We recently announced the launch of our CVS Health Ventures [ph] fund (12:14) that gives us insight into new digital health innovations. This approach allows us to invest in, and partner with, high-potential, early-stage companies to drive technology-enabled innovation and digital health care.

Rising to meet the challenge of COVID-19 has advanced the transformation of the healthcare industry. For CVS Health, the chance to serve our nation at such a critical time has further proven the value of our strategy. We have made significant progress in the expansion of our vaccine and diagnostic businesses. We are focused on building broader capabilities in home health, virtual care and health services. Our investments in these areas, as well as our digital transformation, have allowed us to be there for every meaningful moment of health and will

enable us to capture the lifetime value of each of our customers. And finally, we are exploring every avenue for growth and increased returns. Accordingly, we will hold our 2021 Investor Day on December 9, hopefully in New York, conditions permitting, where the management team and I will more fully outline our longer-term strategic priorities and our financial roadmap for sustainable, profitable growth.

In closing, our results this quarter show that our strong brand and national presence is allowing us to meet individuals where they are. It makes us an increasingly integral part of their everyday health.

Now, I'll turn it over to our Chief Financial Officer, Eva Boratto.

Eva C. Boratto

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

Thanks, Karen, and good morning, everyone. As Karen stated, our strong performance across the enterprise continued in the first quarter. We delivered solid revenue growth of 3.5% as a result of strong, net new business plus the expansion of our successful COVID-19 testing and vaccine programs. Adjusted earnings per share of $2.04 increased 6.8% and exceeded our expectations. Our cash flows remain strong, generating $2.9 billion of cash from operations. We paid down over $3 billion of long-term debt in the quarter, while returning $656 million to shareholders through dividends. Since the close of the Aetna transaction, we have paid down a net of more than $15 billion in long-term debt, and we remain on track with our low three times leverage goal in 2022.

We are maintaining our disciplined capital allocation strategy and managing our balance sheet to generate additional cash flows. Across the company, we are executing on our modernization and cost savings initiatives, for which technology is at the core. As mentioned last quarter, we implemented an AI-enabled capability to efficiently address COVID-related calls. This intelligent agent addressed over 8 million calls for frequently asked questions, and we are expanding this technology to call centers across the enterprise.

We are also using AI and other technologies to simplify our prior authorization processes. We are decreasing the workload on providers and shortening the time it takes to get patients on appropriate therapy. This improves the overall patient experience, while maintaining the clinical rigor, quality improvements and safety programs that are vital to our clients. We have taken advantage of the increasing virtualization of work to rethink our infrastructure and are on-track to close 63 non-retail facilities, resulting in a 2.5 million square foot reduction in office space by the end of Q2. We're pleased with our progress to date on these initiatives, and significant opportunity remains.

Now, let's take a look at our results by segment. Our Health Care Benefits segment total revenues increased 6.7% year-over-year, driven by continued growth in our Government Services business. The repeal of the HIF and Medicare risk adjusted revenue pressured that result. Total membership increased about 215,000 sequentially, with Medicaid membership up about 100,000 or 4%, driven by the continued suspension of eligibility redetermination and the new business win of Kentucky Foster's program effective January 1. Our Medicare portfolio continues to grow, with Medicare Advantage and Med Sup membership increasing sequentially about 230,000, up over 6%. Within our PDP, membership increased nearly 4% sequentially. Converting existing Commercial and PDP members to Medicare Advantage is one of our core growth strategies in Government Services. Included in these results are a sequential decline in Commercial membership of about 120,000 members, driven by continued in-group attrition as well as the successful conversion of Commercial to Medicare Advantage.

Our MBR for the quarter of 83.2% represents an increase of 80 basis points compared to prior year. While medical cost in the quarter were generally consistent with historical baseline levels in aggregate, the MBR was negatively impacted by the repeal of the HIF, by approximately 140 basis points and lower Medicare risk-adjusted

revenue. Offsetting these factors were the benefits from improved performance in Medicaid, which was pressured in Q1 of 2020 and prior year's development. Of note, given the lower MBRs in 2020, portions of the prior year's development will be returned to clients and plan sponsors for contractual and regulatory requirements.

Bringing these factors together, along with the impact of our cost reduction initiatives, adjusted operating income was $1.8 billion, up 19.5% year-over-year. We are increasing our Health Care Benefits segment full year adjusted operating income guidance to $5.25 billion to $5.35 billion as a result of our performance to date and our current assumptions, including the extension of sequestration. Our guidance includes our best estimate of medical costs for the remainder of the year, with medical costs modestly elevated. This assumes non-COVID utilization returning towards normal baseline levels and continuing COVID costs largely related to testing and the administration of the vaccine.

Now, I'll move on to Pharmacy Services. Total revenues increased nearly 4% versus last year, primarily driven by net new business wins, specialty pharmacy growth and product mix. Brand drug price inflation of mid single digits was in line with our expectations. Revenue continues to be negatively affected by price compression as well as the weak cough, cold and flu season, which affected claims growth by approximately 230 basis points. We are through just over 65% of renewals for the 2022 selling season, with strong retention, including the retention of the retail and mail contracts with FEP and the return of FEP for specialty.

Adjusted operating income in Pharmacy Services increased 27.7% compared to the first quarter last year. This growth was fueled by improvements in purchasing economics, the ongoing benefits to our clients and CVS Health from the wrap of several specialty generic launches and our specialty trend management programs, which continue to drive value in the marketplace. We are increasing our adjusted operating income guidance to $6.15 billion to $6.25 billion to reflect our performance to date and trends in the business, partially offset by the required investments to prepare to onboard the FEP specialty business in 2022.

And now, let's review Retail/Long-Term Care. Before I get into the components of the P&L, let me start by discussing the effects of the weak cough, cold and flu season, which led to script and front store declines of approximately 300 basis points and 425 basis points, respectively. Overall, it drove about 40% of the adjusted operating income decline for the quarter. Moving on to the P&L, total revenues grew 2.3%, with scripts essentially flat year-over-year. COVID diagnostic testing and vaccine administration were accretive.

The year-over-year revenue comparison includes the headwind from the acceleration of prescriptions and front store demand in March of 2020, as we served our customers and members at the start of the pandemic. During the quarter, we continued to gain share with an increase of 42 basis points. Gross margins in the segment declined 30 basis points versus Q1 of 2020, driven by continued reimbursement pressure, mix of front and pharmacy revenues, partially offset by COVID-19 testing. Adjusted operating income declined 26.7% year-over-year, reflecting the items I've discussed as well as cost related to COVID-19 testing and long-term care vaccination programs, and severe weather-related cost in Q1 of 2021.

At this time, we are not changing our Retail/Long-Term Care segment guidance, as the benefit from the higher COVID-19 vaccine administration fee is offset by a slower-than-anticipated return of front store traffic and many unknowns, such as urban market recovery and vaccine hesitancy. Bringing all of the pieces together, we are increasing our 2021 adjusted earnings per share guidance to $7.56 to $7.68, up from our prior guidance of $7.39 to $7.55. Consistent with our prior guidance, COVID-19 is expected to have a minimal impact on consolidated financial results for the year. You can see further details of our changes in the slide presentation we posted to our website.

We continue to expect strong cash from operations between $12 billion and $12.5 billion, and our gross capital expenditure expectations remain at $2.7 billion to $3 billion to fund organic growth initiatives. We continue to expand our investments in technology and digital, as we work on creating a seamless omni-channel consumer experience, bringing healthcare services to meet consumers' needs at the most appropriate time and place. Our enterprise cost savings initiatives are on track to generate $900 million to $1.1 billion, and these savings are expected to ramp as we move throughout the year.

Consistent with what we spoke about in February, we continue to expect our earnings cadence to be somewhat fluid over the course of the year. Based on our current estimates, which includes COVID-19 vaccines more heavily weighted to the front half of the year, we expect approximately 54% of our annual earnings per share in the front half.

In summary, we continue to meet the needs of our clients and consumers. This allows us to generate substantial cash to deliver on our financial commitments, to invest in our company and to return value to shareholders. We've executed against our growth commitments and are well positioned to deliver sustainable, long-term growth.

Let's now open it up for your questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] We'll take our first question from Ricky Goldwasser with Morgan Stanley. Please go ahead.

Ricky R. Goldwasser
Analyst, Morgan Stanley & Co. LLC

Q

Hey, good morning, and congratulations on a very good quarter. So, my question is focused on the PBM segment, I mean, clearly it was a very strong performance and really trying to understand the moving factors. You mentioned specialty and improved purchasing, so on the specialty side, maybe you can give us a little bit more color on what are the specific products. It seems like you were alluding to biosimilar performance, so what type of adoption you're seeing and then also the improved purchasing, there's a lot of questions we're getting from investors around generic pricing environment, so I wanted to see what you're seeing there. Thank you.

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

A

Good morning, Ricky. I'll start and I'll hand it off to Alan to give you more specifics. But as we mentioned, we continue to see very strong growth in the PBM business, really fueled by strong purchasing economics, the wrap of our specialty trend programs. And more importantly, you saw we announced last week that we had really strong trend management with average trend of 2.9%, truly resonating in the marketplace. The other thing I would mention, Ricky, is that the integrated value story between medical and pharmacy continues to resonate with our employer groups, and we've had strong success there. But let me turn it over to Alan. He can give you some more detail.

Alan M. Lotvin
Executive Vice President & President - Pharmacy Services, CVS Health Corp.

A

Yes, good morning, Ricky. How are you? So, as you think about kind of the economics across specialty, you sort of think about it in a couple of categories. So, one is you generally improve purchasing economics across brands

as well as generics, right? So, that allows us to create greater value for our customers as well as meet all the obligations that we've created there. Then, they're successfully executing against programs that take advantage of the generics that launched late last year were also critically important, right, so we were able to drive generic dispensing rates to levels that were a little bit higher than I think we initially thought, and that both benefits us as well as our clients. Those are the principal drivers of the economics within specialty, and then as Karen and Eva mentioned in their remarks, continuing to drive outstanding specialty trend is what allows customers to continue to choose us to manage our specialty spend, as FEP did, so again it becomes a self-reinforcing cycle.

Ricky R. Goldwasser
Analyst, Morgan Stanley & Co. LLC

Q

Great. Thank you. And just a quick follow-up on the vaccine. Just to clarify, when you think about the vaccine benefit, clearly you saw an improvement in reimbursement rates. Given that we're seeing some hesitancy around vaccine and it seems that we might have seen it peak in growth there, are you now assuming lower vaccine volumes for the year versus what you assumed in prior guidance?

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

A

Ricky, this is Eva. I'll take that one. Overall, as you said recently, we have seen some vaccine hesitancy. We've seen a drop off of around 30% as you look at some of the recent data there. The initial outlook we had provided was it was about a 2% to 3% contributor to our overall volume growth. Right now, we're probably trending at the lower end of that range, given performance to date and what we're seeing in the market. In our outlook, we are assuming the pediatric vaccine, but what's not included in our current estimates is the impact of a booster should there be one later this year, or...

Ricky R. Goldwasser
Analyst, Morgan Stanley & Co. LLC

Q

Thank you.

Katherine K. Durant
Senior Director, Investor Relations, CVS Health Corp.

A

Next question, please?

Operator: We'll go to Steven Valiquette with Barclays. Your line is open.

Steve J. Valiquette
Analyst, Barclays Capital, Inc.

Q

Great. Thanks, good morning, everybody. So, within the HCB or Aetna segment, the MLR came in better than expected. There also seems to be some investor focus on the better-than-expected SG&A in that segment as well, so I'm curious if you [ph] can provide (29:59) some of the operating expense and...

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

A

Hey, Steve, we're having a hard time hearing you, so I wonder if you could speak up.

Steve J. Valiquette
Analyst, Barclays Capital, Inc.

Q

Is this any better?

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

Much better. Thank you.

Steve J. Valiquette
Analyst, Barclays Capital, Inc.
Q

Okay. Sorry, not sure what happened there, so I apologize. My question was just on the HCB or Aetna segment. The MLR came in better than expected but there also seemed to be some investor focus on better-than-expected SG&A within that segment as well. So I was curious if you're able to just speak to the operating expense trends within Aetna. And also if I missed it, if you gave the prior-year development number, just to have that handy as well within HCB. Thanks.

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

Yeah, I'll start and I'll hand it to Eva for prior period development. On the cost – on the expenses for Aetna, last year and we continue to do this every year is we continue to look for ways to improve our overall cost efficiency. We embarked on initiatives last year using technology, looking at ways we can be more competitive, and that's reflected in the first quarter results in the segment. And as you might expect, we continue to do that across the company, as I mentioned in my prepared remarks. We, every year, continue to look at ways to become more efficient, and we are really trying to harness technology to make those efficiencies real, and the healthcare benefit really did see the effects of that in the quarter. Eva do you want to talk about the prior-year period development?

Eva C. Boratto
Chief Financial Officer & Executive Vice President, CVS Health Corp.
A

Sure, Karen, thanks. Good morning, Steve. Overall we did experience elevated prior-year development in the quarter. However, when you look at it on a financial statement net basis, given the MLR MBR contractual requirements, I would say it's really not that unusual compared to prior years.

Steve J. Valiquette
Analyst, Barclays Capital, Inc.
Q

Okay. Got it. Okay. Thanks.

Katherine K. Durant
Senior Director, Investor Relations, CVS Health Corp.
A

Next question, please?

Operator: We'll go now to Lisa Gill with JPMorgan. Your line is open.

Lisa C. Gill
Analyst, JPMorgan Securities LLC
Q

Thanks very much. Karen, I want to go back to your earlier comment when you talked about behavioral health and connecting the consumer with the best site of care. Can you talk about how you're doing that specifically, how you're contracting with behavioral health specialists, if these are psychiatrists or psychologists and how that really feeds into a broader comment that you made around the consumer, talking about the home virtual community?

How do I think about all those elements working together when we think about both mental health and physical health?

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

A

Good morning, Lisa. Well, I think relative to behavioral health, it is critically important for us to focus on it. The pandemic has increased the number of behavioral health interactions, and I think what we've seen in the – with individuals we've seen increases in substance abuse. We've seen increases in domestic violence. We've seen increases in depression and anxiety. What we've done is we have put licensed clinical social workers in a certain number of our HealthHUBs. And what we are trying to do is really connect the physical health with the mental health.

In every single MinuteClinic, we do behavioral health screenings. They then will be referred to our licensed clinical worker that is in the facility, in the HealthHUB. And then we can connect with them digitally as well through our E-clinic capabilities. And we are actually seeing very strong results in this program. We're seeing three visits in a month from those individuals that have already engaged with us, so clearly, there's a need to make those connections. It is a differentiator for us and something that I believe is important as you think about mental health and physical health combining to take care of the holistic person and then meeting them where they want to be met.

Quick customer story, Lisa. We had an individual reach out to us. She was trying to get into see a behavioral health provider. She couldn't and when she – it took her a month and then after a month they told her it would take another month for her to get an appointment. She learned about CVS Health, and we got her in the same day. So there is definitely a need, and I'm very excited about the possibilities for us to really enhance our products and services to support the holistic health of individuals.

Lisa C. Gill
Analyst, JPMorgan Securities LLC

Q

And how do we think about that like from a financial perspective, Karen? Is this that these are Aetna members and therefore you're going to be able to lower overall healthcare costs for that member because we keep them well both mentally and physically? Or is this a program where you're charging fee-for-service to other plan members? And is this going to be a big enough driver? And is there an attachment rate to those? Just how do we think about some of the opportunities around this?

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

A

Yeah, the way to think about it and I'll hand it over to Neela. It's broader than just Aetna because we have contracts with other managed care plans. So they are coming in. It is part of their insurance coverage and that's how kind of the economics of it. Let me ask Neela to talk a little bit more in detail.

Neela Montgomery
Executive Vice President and President, Retail/Pharmacy, CVS Health Corp.

A

Hi there. I would say that we are using insurance at the moment, and that's the main way in which people are accessing care. As Karen mentioned, access is a huge factor and the convenience of evenings and weekends in our proposition makes it very desirable to customers. Over time we do expect to grow this sort of [ph] deep seed (35:39) fee-for-service business because we do recognize that's a large part of the market, and we expect to launch that next month.

Lisa C. Gill
Analyst, JPMorgan Securities LLC

Q

Thank you.

Katherine K. Durant
Senior Director, Investor Relations, CVS Health Corp.

A

Next question, please?

Operator: Our next question comes from A.J. Rice with Credit Suisse. Your line is open.

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

Q

Hi, everyone. Just to start out, I really appreciate the comments about how Aetna's integrating with MinuteClinic and HealthHUBs for new product offerings. That seems like the principal way the three businesses are maybe integrating. But I wondered, two years into the deal, are there other things you'd highlight as to why the three individual businesses are better all together and things you've realized from the deal that may be worth highlighting to people beyond that?

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

A

Good morning, A.J. I think there are a number of things. You mentioned MinuteClinic. I would say the integration of medical pharmacy is another area. We've also put out a number of clinical programs that we are advancing as part of the overall combination of the three companies; our diabetes program, our chronic kidney program, our oncology program. All those programs demonstrate the value of an integrated offering, where we have those programs and we can meet people either in the MinuteClinics, we can meet them at home and obviously, manage their insurance coverage. So, there are a number of different proof points. We're also leveraging technology and analytics through our next-best action. And then I would say our new programs like our Return Ready program is another demonstrable impact of having a combined company where we have the ability to sell our testing and our vaccine programs to our employer groups and then engage them in their sites or in our MinuteClinic. So a number of things that I would point to that demonstrates the value of the combined three companies.

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

Q

Okay. Maybe just a quick additional question. On the – we're seeing a lot of the companies in the sector pursue service, incremental service opportunities through acquisition. I know you guys are still highlighting the priority for capital deployments just to contain or reduce debt. But how should we think about your interest in some of the service line extension provider extensions that we're seeing others do? Is that of interest to you? How should we think about that?

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

A

Yeah, A.J., thank you for that question. Obviously, you mentioned our first and foremost priority is capital deployment to pay down debt. But clearly, we are looking at all of our options around additional services, as demonstrated by our virtual care offerings and things like that, but yes, that is something that would be of interest to us and let me turn it over to Eva.

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

A

Thanks, A.J., good morning. What I'd add to, Karen, certainly paying down our debt remains a top priority. Additionally, I'd remind you that in the outlook provided we did provide for what I'll call smaller M&A to fill out the businesses and where there are needs and we continue to invest organically as well in terms of our CapEx spending and building out the services and capabilities to drive the business forward.

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

Q

Okay. Thanks.

Katherine K. Durant
Senior Director, Investor Relations, CVS Health Corp.

A

Next question, please? Thanks, A.J. Next question?

Operator: Our next question comes from Michael Cherny with Bank of America. Your line is open.

Michael Cherny
Analyst, BofA Securities, Inc.

Q

Good morning, and thanks for the color so far. I want to dive a little bit back into some of these sourcing dynamics that you're seeing. As you think through the component in particular on both generics and specialty, you called it out for the Pharmacy Services Segment as a whole. How does that factor in across the entire enterprise? And how should we think about the durability, especially given that you're easily the largest purchaser in the world of drugs on some of these ongoing sourcing efficiencies, especially in a world where generics as a whole are pretty close to 90% of the total market?

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

A

Good morning, Mike. It's Eva. Thanks for the question. Overall, we source our generics consistently for the entire enterprise, whether it's the Retail/Long-Term Care segment or the PBM segment. And obviously, there've been some specialty generics launches that we've been able to optimize the benefit of that, given our size and scale and our capabilities within the company.

I would just remind you, the economics of specialty manifest themselves on the PBM segment with our Specialty Connect program, and so you'll see the benefits from that program there. And I think to your question around durability, right, we do see new generics continuing to come to market, availability of biosimilars to provide longer-term benefits. And Alan will provide a little bit more color on that.

Alan M. Lotvin
Executive Vice President & President - Pharmacy Services, CVS Health Corp.

A

Yeah, Michael, if I could just add, as you know specialty is somewhere north of 50% of the total drug spend right now. And given the evolution of the FDA around substitutability biosimilars as well as traditional generics for older small molecules, the specialty business is sort of entering that phase of increased competition. So as we look forward over the next two, three, four years, we see a very robust pipeline of both generics and biosimilars in specialty, which while, to your point, the generic dispensing rate is now 90% given the dollar volume is still largely in specialty creates ongoing opportunity for us.

Michael Cherny
Analyst, BofA Securities, Inc.

Q

Thanks. And just one more really quick question. I know you don't guide quarterly, but what's implied on the next year's cough, cold, flu season in terms of how to think about the trajectory of the business since the end of the year?

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

A

Mike, if I could predict the cough, cold season, that would be a great skill to have. But what I'd say is as you look we are assuming the economy continues to return to normal levels as people are vaccinated. What happens with the cough, cold, flu season will affect the segments differently. Obviously, lower medical cost if it's a weak cough, cold, flu season again, and lower scripts on the Retail/Long-Term Care segment. So overall, I'd think about it at the more normal-ish level, but when there's variability, it'll affect the different segments differently.

Michael Cherny
Analyst, BofA Securities, Inc.

Q

Understood, thanks.

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

A

Next question, please?

Operator: Our next question comes from Eric Percher with Nephron Research. Your line is open.

Eric Percher
Analyst, Nephron Research LLC

Q

Thank you, Eric and Josh Raskin here. A question on the Retail segment and pharmacy reimbursement pressure. As we enter a new year, we always see a comment on reimbursement pressure, and I know there have been strategies to drive volume, or increase Pharmacy Services and of course integrated opportunities. But when you look at reimbursement pressure itself, does it remain the same type of headwind that it has over prior years? And what are the strategies you've implemented that can offset that actual reimbursement pressure?

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

A

Hi, Eric and Josh. A couple things on reimbursement. We recognize that this continues to be a challenge for us, and what we are currently working on are revising our contracting strategies, continuing to manage cost initiatives and clearly managing our supply chain in an appropriate way. As I mentioned on the call, we're exploring all of our options here and I think we'll have more to talk about in December. And let me just see if Eva has anything to add here.

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

A

As Karen said, Eric, we have volume, we have cost and we have Red Oak to continue to unlock value. As you saw, we're looking on the cost front, beyond the purchasing side, we're looking at ways to continue to reduce operating cost in our operations utilizing technology and really trying to lower the cost.

Eric Percher
Analyst, Nephron Research LLC

Q

Thank you. And on the biosimilar side, when we see the sourcing benefits, is that in part reflecting success with the new Zinc entity? Or does that fall into Red Oak?

Alan M. Lotvin
Executive Vice President & President - Pharmacy Services, CVS Health Corp.

A

So biosimilars would flow through our traditional Caremark contracting. Part of that is within Zinc and part of that is directly through Caremark, not through Red Oak.

Eric Percher
Analyst, Nephron Research LLC

Q

Thank you.

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

A

Next question, please?

Operator: We'll go now to Bob Jones with Goldman Sachs. Your line is open.

Robert P. Jones
Analyst, Goldman Sachs & Co. LLC

Q

Hi, great. Thanks for the question. Maybe just to go back to the HCB segment and the strong performance there and the subsequent guidance raise of $150 million at the midpoint, I know there's obviously a number of moving pieces that inform the guidance, but I was hoping maybe you could just break out and to talk a little bit specifically about the sequestration extension and how maybe any updated views on utilization helped inform that raise for the full year.

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

A

Good morning, Bob. It's Eva, and as you said, we delivered strong performance in the quarter and our outlook remains strong, so I'll try to give you four key pieces what we reflected in that outlook. Our performance to date and I commented earlier the benefits from prior year's development. Think about that generally on a net basis, not that different from what we've seen previous years given where MBRs were for 2020 in our client and contractual requirements.

We have included sequestration through the end of the year. And as you think about medical costs, we've updated our medical cost assumptions for two areas. One, we continue to incur COVID-related costs, driven largely by testing and vaccine spend, and those costs are at lower levels than the first half of the year, given as people become immunized, the treatment costs we expect to decline. As it pertains to non-COVID utilization cost, we expect it to return to more normal seasonal baseline levels, particularly in the second half. And our outlook for membership remains consistent with what we provided previously.

Robert P. Jones
Analyst, Goldman Sachs & Co. LLC

Q

Great. That's helpful. I guess just one quick follow-up within HCB around the decision to get back into the exchanges in a more meaningful way. Any updated thoughts or latest thoughts on the strategy? Kind of what the go-to-market will be, who you'll be targeting with it and the exchanges relative to some of the other offerings out there. That would be helpful to get your latest thoughts on that. Thanks.

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

A

Hi, Bob, it's Karen. First, I would say that given that we're entering into the exchanges, that's a market that we have 12 million to 15 million people that we don't have access to today. We are clearly going to offer an Aetna-CVS branded product. We will continue to have our narrow networks, and we are in the midst of filing rates. So I don't want to give too much competitive insight or information. And let me see if Dan Finke has anything else he wants to add here.

Daniel P. Finke
Executive Vice President, CVS Health and President, Health Care Benefits Segment (HCB), Aetna., CVS Health Corp.

A

Sure, thanks, Karen. So as Karen stated we're excited about the opportunity to enter the individual market. We are in the middle of the filings, as Karen stated. We're taking a really disciplined and deliberate approach to selecting those states. One of our opportunities is really to connect our strategies around the use of CVS assets, and so we're really looking forward to opportunities around our digital and physical assets, enhancing some of our pharmacy support with those offering and of course, giving access to our MinuteClinics and our HealthHUBs, and so we're really excited to bring this new and different offering to the marketplace.

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

A

Next question, please?

Operator: Our next question comes from Justin Lake with Wolfe Research. Your line is open.

Justin Lake
Analyst, Wolfe Research LLC

Q

Thanks. Good morning. First question. I just wanted to follow-up on the PBM outperformance. It's been pretty incredible over the last three, four, five quarters. I know your purchasing is very strong there, but not seeing the same performance at your peers. So I'm wondering if there's anything you feel like you're doing differently in terms of that generic specialty opportunity, your purchasing with Zinc, et cetera, that might be allowing for that outperformance versus your peers here.

Alan M. Lotvin
Executive Vice President & President - Pharmacy Services, CVS Health Corp.

A

Hi, it's Alan. Thank you for the question. I think the key drivers here are paying really close attention to creating competition, right, to driving more value for our customers which enables us to bring on more volume. I think one of the things that we should also talk about [indiscernible] (50:25) two things, right. So first is the purchasing and the performance around generics and specialty agents. The second is we have – a good portion of our businesses is what we will call open market where there's choice.

We're very aggressive in talking about the benefits to members and patients from an experience perspective of both Specialty Connect and Specialty Expedite. And so that's, again, an example of how we use the entire

enterprise to create better experiences and ultimately more value because it drives volume. So it's a combination of volume. It's a combination of attention to detail and performance on the generic side, and it's as you said, purchasing economics that continue to drive and look for opportunities where we can create more competition to drive more value.

Justin Lake
Analyst, Wolfe Research LLC

Q

That's helpful. And a quick follow-up.

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

A

And then – sorry, Justin. It's Eva, Alan just to add, performance overall remains very strong. We had a very strong welcome season this year, and client satisfaction remains high, which, Justin, as you know in the PBM sector is critical.

Justin Lake
Analyst, Wolfe Research LLC

Q

Sure, thanks for that. And then just a quick follow-up on the transformation targets you laid out with the deal. Those are expected to be a big benefit for 2022. So I was hoping to get some, any kind of updated color on HealthHUBs versus the 1,500 target and how you feel about that transformation number of 850 as you kind of look ahead to next year.

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

A

Hey, Justin, I'll comment on the HealthHUBs and Eva can give the transformation update. Just on HealthHUBs, we have about 800 HealthHUBs now, we built about 250 during the quarter. We do expect to get to about 1,000-ish by the end of the year. What I would tell you, I'm not really looking at the number, I'm looking at coverage.

I think coverage is the more important metric here, and right now, by the end of the year, we'll be 60% coverage on the Aetna Caremark business. We'll be about almost 50% of the US population, so that's really how I think about the hubs and how we get coverage versus the exact number.

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

A

And Justin, on the transformation, you heard throughout Karen's comments and some of the proof points that we've brought, I would say how we're unlocking value is, A, focusing on driving medical cost savings, two, our ability to win new lives in the marketplace by having these differentiated products and services and continuing to sell into new customers and in an open market type of way. So as you look specifically, we're pleased with how transformation is running, and as Karen said, we'll outline more at our December Investor Day.

Justin Lake
Analyst, Wolfe Research LLC

Q

Thanks.

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

A

Operator, we have time for one more question.

Operator: We'll go to Lance Wilkes with Bernstein. Your line is open.

Lance Wilkes
Analyst, Sanford C. Bernstein & Co. LLC

Q

Yeah, good morning. Could you just talk a little bit about the omni-channel strategy? And in particular, in the home health or the home focus, what sort of populations and offerings are you looking at there? And then just maybe secondarily, just asking about how you're going to organize these efforts and manage them within the company. Is HealthHUB, home and virtual all going to be managed together? Or how are you going to work that out as well?

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

A

Well, Lance, on the operating model, we continue to evaluate the best approach to managing our business. And more to come on that. Let me ask Alan to talk about our home strategy, as he's developing our overall home services strategy.

Alan M. Lotvin
Executive Vice President & President - Pharmacy Services, CVS Health Corp.

A

Yeah, thank you, Lance. So it's Alan. As we think about home, I think about home as a really important channel as part of that evolving care delivery, right? We've seen a change in how people expect to receive many things after the pandemic including care. So as we think about it, it's how do we create products and services that are either partly or entirely delivered in home that help us both differentiate on the medical cost savings side, create new experiences for customers, or take advantage of specific technologies.

So whether it's our home dialysis program which is in process or Coram or new virtual care products that supports specific populations, that's how we're thinking about home. But it's about meeting the customer need or the member need first, rather than focusing explicitly on a channel and how do we integrate across all of the touchpoints we have, whether they're digital, virtual, physical in the home, or local.

Lance Wilkes
Analyst, Sanford C. Bernstein & Co. LLC

Q

Great. And just understanding it for the home aspect, obviously infusion and some of the drug-specific opportunities present themselves there. In addition, there's kind of the stabilization that might be important for an MA population like home health. And there's the emerging spaces and kind of frail elderly with physicians. As you're talking about home, are you thinking about one area over another as far as your areas of focus?

Alan M. Lotvin
Executive Vice President & President - Pharmacy Services, CVS Health Corp.

A

So, Lance, I'm sorry I wasn't clear enough. So when we think about specific populations, exactly the populations you're talking about, people transitioning out of the hospital who are frail, keeping them out of the hospitals, keeping them out of skilled nursing facilities by using more virtual services, and physical services in the home are a core population. That's an example of how we would enable, for example, the Health Care Benefits business to be more effective at managing their risk. So that's exactly a population we would be looking at, in addition to the ones you traditionally expect us to look at like drug and dialysis.

Lance Wilkes
Analyst, Sanford C. Bernstein & Co. LLC

Q

Great. Thanks.

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

Before we conclude today, I'd like to leave you with three points that I hope you took away from the call. First, our integrated healthcare model is unique and it is driving growth. You can clearly see that in our financial results across our business, but you can also see it in different ways that we're interacting with our customers.

Second, we are increasingly using digital and technology to redefine the health experience and to improve our cost structure. And finally, we are making significant progress and are well-positioned to deliver growth against our strategy. So thank you all for joining us today.

Operator: This concludes today's CVS Health first quarter 2021 earnings call and webcast. You may disconnect your line at this time. Have a wonderful day.