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ATH - Q2 2003 Anthem, Inc. Earnings Conference Call

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Please note this transcript has been edited for accuracy.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the Anthem quarterly results conference call. At this time all lines are in a listen-only mode. Later there will be an opportunity for questions. Instructions will be given at that time. If you should require assistance during the call, please press star, then 0, and as a reminder, this conference is being recorded. I would now like to turn the conference over to Anthem management. Please go ahead.

Tami Durle *- Anthem - VP of Investor Relations*

Good morning, and welcome to Anthem's second quarter 2003 Earnings Conference Call. I'm Tami Durle, Vice-President of Investor Relations, and with me are Larry Glasscock, Anthem's President, Chairman and Chief Executive Officer, and Mike Smith, Chief Financial Officer. This morning Larry will discuss our second quarter performance followed by Mike who will review our financials in more detail. Before opening up the call for questions Larry will provide a earnings outlook for the rest of 2003. We will be making some forward-looking statements on this call.

Listeners are cautioned that there are factors that could cause actual results to differ materially from our current expectations. These risk factors are discussed in our press release this morning, the form 10-K we filed with the SEC on April 30 of this year and other periodic filings we have made with the SEC. Also, in connection with new SEC guidelines we have provided a reconciliation of reported net income per share and adjusted net income per share, which is a non-GAAP measure, in either both our press release and our web site at Anthem.com. Larry.

Larry Glasscock *- Anthem - President, Chairman and CEO*

Thank you, Tami, and good morning, everyone. We are very pleased to report that Anthem's operational and financial momentum is continuing into the second quarter of 2003. The performance in the quarter was better than we expected, and included many record achievements. Adjusted net income was $1.30 per diluted share in the quarter, a 31% increase year-over-year, and represented the best quarterly performance in our history. Operating revenue also reached an all-time high of almost $4.1 billion in the second quarter. Operating gain was $268 million resulting in a 6.6% operating margin in the quarter, both records for our company. And finally, membership gains of 10% over the prior year on a same store basis and 6% since December increased our enrollment to 11.7 million members, the highest level our company has ever achieved.

Our growth strategy continues to be executed with discipline by all 20,000 of our associates, and has resulted in improved financial performance, operational excellence and better health outcomes for our members. We expect our current momentum to continue, and we are now projecting 2003 adjusted net income of $5.10 to $5.15 per diluted share. This represents an increase of 10 cents per share compared to our previous expectations and a 24% to 25% growth rate compared to 2002. Our improved earnings outlook for '03 is due to continued pricing discipline, relatively stable medical cost trends, and higher enrollment expectations.

Premium yields on our fully insured group business were 12% with medical cost trends of approximately 11% on a rolling 12-month basis. We continue to price our business to cover medical cost trends, which we now expect to be in the 10.5% to 11.5% range for the full year.

Our pricing discipline is also supported with very good flexibility in terms of our renewal patterns. Approximately 35% of our fully insured group business renews in the first quarter, 20% in the second quarter, 30% in the third, and finally 15% in the fourth quarter of the year. We believe we are also well positioned from a product and service perspective to meet the needs our customers. Two metrics that we use to evaluate our ability to provide the right products and services to our customers are membership growth and retention. Anthem added a record 483,000 members during the first quarter with another 205,000 new members in the second quarter. We are on track to achieve 7% to 8% membership growth in 2003, which is better than our previous expectation of 5% to 7% growth for the year and very importantly, we continue to retain over 90% of our existing members. At the end of June our medical membership was 11.7 million, an increase of 41% on a reported basis and 10% growth on a same store basis since the second quarter of 2002. Enrollment gains were achieved in all four geographic regions and, more specifically, in all nine of our states. Compared to last year's second quarter, membership in the Midwest has grown by 465,000 or a 9% increase, the East increased by 265,000 members or 11% growth, and the West grew by 8% or 69,000 new enrollees. Although the Southeast was not a part of Anthem at June 30th of last year, this region increased membership by 98,000 members or a 4% growth rate over the past 12 months. Last month the Blue Cross and Blue Shield association announced that total membership in Blue plans hit an all-time high of 88.7 million members at the close of the first quarter.

We have mentioned in the past that we are fortunate to be able to leverage the Blue Cross and Blue Shield brand to attract and retain membership, and the strength of the brand name is contributing to our success and increasing profitable enrollment. Compared to the second quarter of last year, we grew membership in all customer segments other than Medicare Plus Choice. National accounts enrollment, which includes our BlueCard business, increased by 17%, individual by 13%, and both Local Large Group and Small Group advanced 4% on a same store basis. We highlighted our National accounts business on the first quarter conference call and announced that at that time we had won 23 new accounts in the first quarter. During the second quarter we won another 12 accounts for implementation later this year or in January of 2004, and we continue to be optimistic as we look forward to the 2004 new business opportunities.

Membership gains in the Individual market are coming from all of Anthem's regions, with the Midwest reporting the largest enrollment growth. The introduction of more affordable new products and a recognized brand name have attracted new members. Local Large Group and Small Group membership comprise about 43% of Anthem's total enrollment, and we are very pleased with the 4% year-over-year growth in these two segments, especially given the current economic conditions. We think that having the right products, a very broad network of providers, distinctive customer service levels, and the most recognized brand name in the industry all contribute to membership growth. But we are also very focused on medical management initiatives that will allow us to deliver on our mission of improving the health of our members. These initiatives include, among others, identifying and helping our chronically ill members navigate the health care system. We think there is significant opportunity to further improve that collaboration among physicians and health plans and an element of differentiation for Anthem going forward will be our commitment to improve on the fundamental issues in health care as a partner to the physician community. For example, we are recognizing and rewarding physicians and hospitals through a payment system that improved health care quality, patient safety and improved results. Also, we continue to invest in hospital quality programs across Anthem and have further expanded them into Connecticut, New Hampshire, Maine and Virginia. In the Midwest now almost 350 hospitals share best practices to generate efficiency and improve health care outcomes for their patients.

Now I'd look to take just a few minutes to quickly focus on two very important operational initiatives, systems consolidation and the integration of the Southeast region. First, an update on systems. The migration of membership to new systems of choice in the Midwest and East has been going on as you know now for a couple of years. An important milestone was reached this quarter when the Midwest migration was completed, and the East will be essentially finished by the end of this year. The systems migration effort in the Midwest and East have been among the largest and most important projects undertaken by Anthem. Throughout these projects customer service has been consistently high, and in many cases improved for our customers. Our disciplined focus on planning and execution has made these projects successful. On a much smaller scale, the West systems migration project will begin later this year as well as the preliminary planning for the conversion of the Southeast HMO members to FACETS. In total, about 500,000 members in both the West and Southeast will move to new systems over the next couple of years.

We are following the same detailed management processes used in our systems consolidation efforts to integrate the Southeast region.

Under the leadership of Tom Snead and Mike Smith $15 million of synergies were achieved in the second quarter, and we are very confident that we will now realize at least $50 million of synergies this year and at least $75 million in 2004. Recall that when Tom Snead and I announced the Trigon acquisition we projected about $40 million of synergies for 2003 so we are extremely pleased with the progress accomplished by the integration team, and the results in the Southeast region continue to exceed our expectations. We remain hopeful that our pending acquisition of Blue Cross and Blue Shield of Kansas could be completed later this year.

We had hoped that Kansas, the Kansas Supreme Court would render a decision prior to their summer recess, but now we expect a court decision sometime late in the third or fourth quarter. Both Anthem and Blue Cross and Blue Shield of Kansas remain committed to complete this transaction, and we look forward to the opportunity of serving more than 800,000 members in the Kansas health plan. Finally, before I turn the call over to Mike, I would like to recognize and thank Ben Lytle who recently retired as Anthem's Chairman. Ben led Anthem from a single-state insurance plan to a nationally-recognized leader in our industry. Ben's vision and leadership will not be lost, however, as he will continue to serve as a director. Now here is Mike who will discuss our second quarter financial results. Mike.

Mike Smith *- Anthem - CFO*

Thanks Larry, and good morning. In the second quarter of 2003 our net income was $177.3 million or $1.25 per diluted share. Excluding the after-tax impact of net realized losses, net income was $184 million or $1.30 per diluted share on an adjusted basis. This performance resulted in a 31% year-over-year increase in adjusted diluted earnings per share. This morning I will reference same store performance which excludes the impact of the Trigon acquisition. As you recall, we completed this transaction on July 31 of 2002, and as a result the second quarter of last year did not include Trigon's operating results.

Now, taking a closer look at our income statement, operating revenue was approximately $4.1 billion in the second quarter, an increase of 43% on a reported basis and 10% growth on a same store basis.

Operating gain was $268 million, an increase of $149 million compared to last year's second quarter. On a same store basis operating gain improved by $58 million or 49% year-over-year. All business segments contributed to the increase in operating gain, primarily from pricing actions, stable medical cost trends, and membership gains. In addition, operating margin improved from 4.2% in the second quarter of 2002 to 6.6% in the current year's quarter. Of that 240 basis point improvement, 90 basis points was due to the impact of the Trigon acquisition and the remaining 150 basis points from enhanced margins in our other health segments.

In the Midwest, operating gain was $104 million in the quarter, a 69% increase over the second quarter of 2002. Hence, Midwest operating margins improved by 220 basis points to 6.3%. The year-over-year improvement in the Midwest result was impacted by a $12.5 million net favorable prior year reserve development, offset by a $6 million increase to reserves for provider recoveries. Therefore, the operating gain in the Midwest was about $7 million stronger than we had projected for the quarter on a net basis.

Operating gain in the East was $74.5 million in the second quarter, a 41% increase year-over-year. Operating margin improved from 5.3% in the second quarter of last year to 6.7% in this year's second quarter. The East segment’s 11% growth rate in membership over the past 12 months is the highest among Anthem's four geographic regions.

Significant to this double digit enrollment growth are our efforts to further penetrate the National account market and our commitment to distinctive customer service. We think our continued focus on becoming easier to do business with for both our clinical networks and our customers will continue to translate into profitable membership growth.

Our West segment reported a $21.4 million operating gain, $11 million better than the second quarter of 2002. Operating margin improved to 8.4% in the second quarter. As we stated on last quarter's call, spending on systems migration in the West will gradually increase during the remainder of this year. As a result, quarterly margins in the West are expected to decline slightly in the third and fourth quarters with a full-year operating margin in the mid 8% change in this segment.

The operating gain in the Southeast was $91.1 million, resulting in a 9.8% operating margin. The second quarter performance in the Southeast included a $15.8 million net favorable prior year reserve development, offset by $20.4 million for initiatives to further advance health care quality and affordability in the Virginia market. These initiatives include a $10 million contribution to the Anthem Foundation. We continue to be pleased with the strong performance of the Southeast region and expect the full year operating margin to be in the high 8% range.

Our Specialty segment reported a $16 million operating gain and an 8.9% operating margin for the quarter. Compared to the second quarter of last year, operating gain increased by $3 million, primarily due to increased mail order volume at Anthem Prescription Management but partially offset by the integration and buildout of our newer Specialty businesses.

Our pharmacy benefit management operation, Anthem Prescription Management, processed 747,000 mail order scripts in the second quarter, representing a 29% year-over-year increase.

The Other segment’s operating loss was approximately $39 million this quarter, up from $20 million in the second quarter of 2002, primarily due to higher incentive compensation expense as a result of above-targeted performance. We hope you appreciate the transparency we have provided on each of our business segments, and I would now like to quickly summarize the quality of our second quarter operating results. Approximately $31.7 million in net favorable prior year reserve developments were recognized in the quarter, and this was essentially offset by other unusual expenditures and initiatives that were appropriate for us to undertake. We're pleased with the underlying strength of our businesses, and we expect continued improvement as we look ahead to the remaining quarters of the year.

Moving down the income statement, net investment income was $65.6 million in the second quarter. This represented a $6 million increase over the second quarter of 2002 due to a larger investment portfolio, which includes investments from the Trigon acquisition, as well as reinvested cash flow, substantially offset, however, by lower investment yields. Average yields on our fixed income portfolio were approximately 6.2% in the second quarter of last year and yields in the current quarter were about 4.4%. Net investment income declined by about $6 million sequentially due to the lower yields. I want to emphasize our ability to report a 31% growth in adjusted net income per share for the quarter in spite of these declining investment yields.

During the second quarter Anthem realized $13.9 million pretax in investment gains and recognized a $23.3 million pretax loss on impaired equity securities, thus resulting in a $9.4 million net realized loss for the quarter. Our investment portfolio is allocated 98% to fixed maturities securities and 2% to equities, and the quality of the entire portfolio remains very good.

The consolidated benefit expense ratio was 80.8% in the second quarter, an improvement of 280 basis points year-over-year. This ratio improved primarily due to the following: 80 basis points of improvement was due to the recognition of $31.7 million in net favorable prior year reserve developments; the acquisition of Trigon contributed another 60 basis points, excluding the $15.8 million from the favorable reserve developments recognized in the Southeast; and the remaining 140 basis points came from improved underwriting performance and changes in our business mix.

Medical cost trends for our fully insured group business were 11% on a rolling 12-month basis, or consistent with the trend reported last quarter. Inpatient trends were about 10%. Outpatient services about 13%. Professional services around 10%. And pharmacy at 10%.

We expect our 2003 medical cost trend to be in the 10-1/2% to 11-1/2% range for the full year, which is a slight improvement from our previous guidance for trends to be in the 11% to 12% range for the full year. Professional services and outpatient costs continue to be the primary drivers of the overall trend. Utilization trends remain fairly high for professional services, particularly in specialist office visits. Outpatient has been nearly equally driven by both increases in unit cost and utilization, especially in radiology and certain specific diagnostic procedures. The inpatient trend continues to be driven primarily by unit cost increases. Utilization in the inpatient setting has increased in the low single digit range. The pharmacy trend improved from about 16% in 2002 to 10% for the last 12-month period. The improvement in pharmacy trends was impacted by lower utilization in the anti-histamine class of drugs as Claritin moved to over-the-counter status, as well as lower cost from increased generic penetration.

Our administrative expense ratio was 19.1% in the second quarter of 2003, ten basis points better than last year's second quarter. While we have made continued progress in bringing down our administrative costs, these initiatives were partially offset by higher incentive compensation associated with above-target results, merit increases that became effective in April and contributions to the Anthem Foundation. These same items impacted our results on a sequential basis. We will continue to invest in our businesses to support further membership gains and to improve the overall health care system as Larry referenced earlier.

Now focusing on our balance sheet and operating cash flow, cash in investments were $7.1 billion at the end of the quarter, up approximately $500 million from year-end 2002, and total assets reached $12.9 billion. Our unpaid life, accident, and health claim liability was $1.9 billion at the end of the second quarter, up $70 million from the end of last year. Days claims payable were 56.4 days, down slightly by three tenths of a day sequentially.

We included in our press release a reconciliation of our reserves. This disclosure is comparable to the reconciliation provided in our fourth quarter 2002 press release and footnote 8 in our 2002 Form 10-K; however, the 2003 incurred and paid data are for six months of activity rather than a full year. The reserve redundancy that will be recognized in 2003 could increase or decrease from the level disclosed in this morning's press release, which considers only six months of claims runout. Similar to our previous history, this disclosure shows that on a consistent basis our reserves are being strengthened at a faster rate than reserve redundancies are being recognized.

Anthem's total debt level of $1.8 billion at June 30th was unchanged from year-end 2002; however, note that $100 million of debt matured and was repaid on July 15th of this year. Therefore, based upon today's debt balance, our debt to total capitalization ratio would be approximately 22%.

Operating cash flow in the quarter was $145 million, down about $100 million sequentially, primarily due to the following items: The timing of tax payments lowered operating cash flow by $58 million in the quarter, and we contributed $40 million to Anthem's pension trust, also reducing operating cash flow. During the quarter we implemented a new policy of funding the pension plan on a quarterly basis rather than making a single larger annual contribution. And finally, we continue to expect operating cash flow to at least reach $1 billion in 2003, well above our projected net income for the year.

In the second quarter we repurchased 236,000 shares using approximately $17 million at an average per-share price of $71.10. For the year Anthem has acquired 1.8 million shares using approximately $108 million at an average share price of $59.22. We have remaining authorization for $392 million under our share repurchase program, which expires in February of 2005, and we will continue to be opportunistic in acquiring Anthem shares in the future to enhance shareholder value. Now I will turn the call back to Larry who will provide our earnings outlook for the balance of the year. Larry.

Larry Glasscock *- Anthem - President, Chairman and CEO*

Thank you, Mike. Consistent with our past practice, our guidance does not include the pending Blue Cross and Blue Shield of Kansas acquisition or the projection of additional share repurchases. Based on the strength of the first half of the year and continued earnings momentum, we now project full year 2003 diluted net income per share to be in the $5.10 to $5.15 per share range on an adjusted basis. Again, we are very pleased to be able to raise our full year 2003 earnings expectations by 10 cents per share even after taking into account the lower yields expected to be earned by our investment portfolio. For 2004 we continue to be confident in our ability to deliver at least 15% earnings growth as compared to our 2003 guidance which I just reviewed. The following guidance I will provide is on a reported basis.

Our earnings guidance assumes approximately 142 to 144 million average diluted shares outstanding for the full year 2003. Operating revenue should approach $16.5 billion dollars for the full year 2003, and as I mentioned earlier we are raising our expectations for membership growth from 5% to 7% to a range of 7% to 8% for the year 2003. Premium yields are expected to continue to cover medical cost trends of 10.5% to 11.5% for our fully insured group business again in 2003. Operating gain is projected to approach $1.1 billion for the year. 2003 operating gain by segment is projected as follows: Midwest, $425 to $435 million; East in the $295 to $305 million range; Southeast $320 to $330 million; West in the $90 to $95 million range; Specialty $60 to $65 million; and the Other segment operating loss is projected to be in the $135 to $145 million range. Operating margin should be in the mid-6% range for the full year.

We expect the benefit expense ratio to be in the 81.4% to 81.9% range for the year. The administrative expense ratio is projected to improve 50 to 100 basis points in 2003 or a ratio in the 18.3% to 18.8% range, which is slightly higher than our previous expectations. Later this morning all of the guidance I just discussed will be summarized for you under the Investor Relations link on our web site at Anthem.com. So having reviewed the guidance, let's now open the call up for questions.

QUESTION AND ANSWER

Operator

Thank you. Ladies and gentlemen, if you would like to ask a question, please press star, then 1 on your touch tone phone. You'll hear a tone indicating you have been placed in queue. You may remove yourself from queue at any time by pressing the pound key. If you are using a speakerphone, please pick up your handset before dialing. Our 1st question comes from Josh Raskin with Lehman Brothers. Please go ahead.

Josh Raskin *- Lehman Brothers - Analyst*

Hi. Thanks. First question related to membership, if you guys could give us a little bit of a better sense as to where some of that's coming from. Are there any particular areas? Obviously the East was particularly strong and National accounts as a segment, but are there any specific competitors or does it seem to be raw base? And then can you if you could give a little bit of an update as to Large Group 2004 expectations. I know it's still early and you're still sort of finalizing some of those numbers, but maybe even just RFP activity or something like that.

Larry Glasscock *- Anthem - President, Chairman and CEO*

Josh, as you know, we're not giving guidance yet for '04, but let me give you a sense. As I mentioned earlier in my remarks, we had very, very strong membership growth in each and every one of our regions, and we had very good membership growth in each of our nine states, so this is very, very broad based. People have asked us, you're now asking us, you know, where is it coming from. Actually, we're picking up accounts, you know, across the board.

We're very pleased and our customers appear to be very pleased with our value proposition. We have increased our membership, as you could probably see from our distribution earlier this morning, by 688,000 members just since the end of the year, and on a year-over-year basis same store again we're up almost 800,000 members, 799,000 members. To give you a little more on that, the Midwest membership grew about 9%. Again, this is year-over-year. East was up right around 11%. The West was growing over this period about 8%. And as I mentioned earlier, Trigon year-over-year was growing at about 4%. But as you -- as we talked about in the first quarter call, they made some very, as they always do, very disciplined pricing decisions, and that growth could have been much more than 4%, but they were extremely disciplined, as they always have been.

Josh Raskin *- Lehman Brothers - Analyst*

Sure.

Larry Glasscock *- Anthem - President, Chairman and CEO*

National accounts, again is very, very strong. Year-over-year national accounts grew by about 17% and Large Local Group up around 4%. As I also mentioned, Individual is growing very rapidly, up year-over-year about 13%. So given this economy we're in and given our very disciplined approach to pricing, we are extremely pleased with the membership performance.

Josh Raskin *- Lehman Brothers - Analyst*

Sure. And I guess, Larry, just knowing Mike has said in the past if it moves we measure it, do you guys have the quantification of the impact of in group changes, some of your competitors have seen layoffs and groups shrinking within. Have you guys quantified that membership impact?

Larry Glasscock *- Anthem - President, Chairman and CEO*

We have, and we have had a slight reduction in existing account membership. In fact, in the second quarter it was roughly 30,000 members, and, again, that was a little bit higher than we saw in the first quarter.

Josh Raskin *- Lehman Brothers - Analyst*

Okay. And then just one quick question for Mike. In terms of the reconciliation of the $31.7 million prior period favorable development versus I guess it's page 8 of the release, the prior year redundancies of $102 million, I'm just wondering in the first quarter you said there was nothing extraordinary, so should we just think of this as above and beyond last year but obviously those are two different numbers or ...

Mike Smith *- Anthem - CFO*

Absolutely, Josh. Did you intend to refer to the $181 million as opposed to $102 million?

Josh Raskin *- Lehman Brothers - Analyst*

Yes…..I'm sorry, the $181 million.

Mike Smith *- Anthem - CFO*

And, again, you are very correct. There is nothing unusual about this other than our very intent effort to spike out for you that portion of the redundancy that truly is not being replaced in our current consistent, conservative reserve practice. This is over and above, as you described.

Josh Raskin - ***Lehman Brothers - Analyst***

Okay. So -- okay. In the normal course you would have expected similar numbers on a percentage basis to last year, but the $31.7 million represents the amount that is over and above that is not being replenished, as you said?

Mike Smith - ***Anthem - CFO***

That is accurate. And I asked you to recall last year's third quarter when we similarly recognized approximately $27 million, so this is an earlier recognition of the excess in the estimate at the end of the year.

Josh Raskin - ***Lehman Brothers - Analyst***

Okay. That's helpful. Then one quick question for modeling purposes. The non-risk lives are up pretty dramatically and even sequentially in the quarter but yesterday the admin fees were down a little bit. Was there something in there?

Mike Smith - ***Anthem - CFO***

In admin fees there are two things in there, Josh. One is the discontinuation of a 1-800 contract in our fiscal intermediary operation. That's a contract that we talked about earlier in the first quarter and we've been transitioning that to the new service provider throughout the second quarter. The other impact is the $6 million reserve that I spiked out in discussing the Midwest results was actually recorded as a contra revenue in the second quarter of '03.

Josh Raskin - ***Lehman Brothers - Analyst***

Okay. Thanks and congrats.

Operator

Thank you. We now have a question from the line of Charles Boorady with Smith Barney. Please go ahead.

Charles Boorady - ***Smith Barney - Analyst***

Thanks, good morning and great quarter. First question just relates to a balance sheet item on the receivables. Can you explain the change in receivables and what you expect going forward and also give us a breakdown of the components of that, you know, what amounts relate to which major products? There are some products that are taking longer to collect than others, that sort of thing.

Mike Smith - ***Anthem - CFO***

Let me first give you a negative assurance, Charles. Nothing related to the widely-publicized budget crises in the East where, as you know, we hold state accounts in all three of our East region states. The spike this year is primarily related to just a handful of timing-related items. No aging concern, no single item above $30 million driving this increase. The increase specifically is timing, related to timing on collecting ASO receivables at the very end of the quarter and as silly as it may sound, the nuance of the quarter ending on a Monday actually impacts the billing and collection cycle slightly, but no credit deterioration and no large single item in driving that change.

Charles Boorady - ***Smith Barney - Analyst***

Okay. Would you expect that to come down as we hit a quarter that doesn't end on a Monday, for example?

Mike Smith - ***Anthem - CFO***

We most certainly do. We do not expect that growth in receivables to repeat at third quarter end.

Charles Boorady - ***Smith Barney - Analyst***

Great. And then second question on enrollment just a follow on that conversation a little bit because obviously highly unusual to see the strength in your enrollment just posted with what was a disappointment for a lot of others and a higher unemployment, and just to help me better understand why people are moving to Anthem from wherever they were before, and obviously you know the strength of the brand and the network, et cetera, but is there a way to sort of quantify, are you able to have the data to do a side-by-side to look at what your customers, what your new customers' previous product was side by side with your product and to say that on average they're paying X% more or less to make the move and they're buying a more generous or less generous product, et cetera? Just have a flavor for what kind of products people are switching to when they come over to Anthem from their previous carrier.

Larry Glasscock - ***Anthem - President, Chairman and CEO***

Okay. Well, let me -- emeded in there, Charles, is about ten questions, but let me just tell you that I think our strength goes across our entire company, but National accounts, as I said, is doing extraordinarily well, and the vast majority of our growth this year to date is coming from National accounts, and I think the reason for that continues to be really straightforward, and frankly you mentioned several of the reasons. We have the strongest and most recognized brand in health care, and we believe, as we've said many times, that has tremendous, tremendous value. There isn't any question in our mind that we've got the broadest provider networks, and because of BlueCard we give our customers very deep access into all 50 states, into all rural areas, and, you know, as customers consolidate, you know, they're looking for someone, I think, who has that very deep provider penetration. We've also discussed in the past this concept of this new tool that we have called Claims Quest which in a far more rigorous way allows us to display, you know, what benefit really comes out of accessing the Blue networks for our clients, and I think the richness of that analysis is really helping us. And then at the National level, again, I think a very important aspect is the way we approach service. You've heard us say many times that we're dedicated to really high levels of service, but in National accounts we continue to have this dedicated service model, so these major accounts know by name who they're dealing with and that, we believe, gives us a lot of traction, so those are the, I guess, the broad brush reasons. And in terms of product, what we're seeing is lots of interest, as you would expect, in continuing to address the co-pays and the deductibles, the buydowns that we're experiencing are running right where we told you at about 300 basis points. We have expanded our product set. One of the reasons I think, Charles, we're having such good enrollment growth in Individual is we've really introduced a lot of more reasonably priced products, so we have a much broader spread in our portfolio from low price to the higher priced products, so it's a lot of things, tough to put your finger on just one item.

Charles Boorady - ***Smith Barney - Analyst***

On the price part, Larry, just if you had to characterize for your new enrollees are they paying on average more or less or about the same per month with Anthem than they were with their previous carriers? Are you able to know that?

Larry Glasscock - ***Anthem - President, Chairman and CEO***

We couldn't go there, Charles. I wouldn't have a comment on that.

Charles Boorady - ***Smith Barney - Analyst***

Great. Okay. Thanks. Great quarter.

Larry Glasscock - ***Anthem - President, Chairman and CEO***

Thank you very much. Thanks for the question.

Operator

Thank you. Our next question is from Mathew Borsch with Goldman Sachs. Go ahead, please.

Mathew Borsch - ***Goldman Sachs - Analyst***

Good morning and congrats on the quarter. Couple of questions, first on cost trend...if I could just drill down a little bit, and maybe I got this wrong, but it looked like there was a shift on the upside in the inpatient trend which on a rolling 12-month basis I understood to be 7% as of the end of the first quarter and is now 10%? Did I get that right? And can you just elaborate on what some of the changes are there?

Larry Glasscock - ***Anthem - President, Chairman and CEO***

Yes. You got that absolutely right. And what we're seeing in inpatient trend is continuing to be driven predominantly by unit cost, and that represents really about 80% of what we're seeing in the way of increased costs. What we did experience in the second quarter were a few larger than normal claims come through. I mean, it sounds sort of extraordinary, but we very much did see that. We are seeing a significant increase in the use of these recently FDA-approved life-saving technologies, for example, these implantable defibrillators for patients who are really at the high risk of sudden cardiac failure, so we did see, we think, some spike, but nothing that we're concerned about. I mean, our guidance for '03 continues to be in the 9% to 10% range. In the first quarter I think we provided guidance around 8% to 9%. So we're on track for where we expected to be. We're not alarmed by this at all.

Mathew Borsch - ***Goldman Sachs - Analyst***

And would you say just to understand on the unit cost side in terms of your negotiations with the hospitals, are the hospitals on average sort of getting about the same level of rate increase that they were a year ago or is that decelerated or accelerated?

Larry Glasscock - ***Anthem - President, Chairman and CEO***

Yeah, I think it's very similar.

Mathew Borsch - ***Goldman Sachs - Analyst***

Great. And if I could ask just one last question on a different topic which is just, again, on the enrollment question, and, you know, not to name specific competitors, but can you characterize on your National account growth, you know, how much you think is coming from the non-public TPAs that are out there versus from, you know, the big three national carriers?

Larry Glasscock *- Anthem - President, Chairman and CEO*

Well, first of all, what we are seeing is we're winning against the entire gamut of competitors, so there has been -- as I go down and I review that list every month, as I look down where the business is coming from, it's across the board. So I wouldn't suggest that there is any tilt one way or the other.

Mathew Borsch *- Goldman Sachs - Analyst*

Okay. Thank you.

Larry Glasscock *- Anthem - President, Chairman and CEO*

Thank you.

Operator

Thank you. We'll now move on to the line of John Rex with Bear Sterns. Go ahead, please.

John Rex *- Bear Stearns - Analyst*

Good morning. Thank you. Just curious, as you look out for early quotes on '04 business and you're kind of incorporating what you're seeing on price trends from a pricing standpoint would your view still be on pricing the existing 12-month average or are you inclined to incorporate any assumptions yet as you see continued deceleration there?

Larry Glasscock *- Anthem - President, Chairman and CEO*

We're continuing to price at the levels we've been discussing in the recent past, so, you know, as I said, we're looking at medical cost trend in the 10.5% to 11.5% range, so -- and as we've said many times, we're pricing to make sure we cover trends, so ...

John Rex *- Bear Stearns - Analyst*

Any significant difference between the -- between the 12-month rolling trend, and if you could discreetly say what you just saw as trend in the quarter?

Larry Glasscock *- Anthem - President, Chairman and CEO*

In the quarter it was 10%.

John Rex *- Bear Stearns - Analyst*

I think that was similar to last quarter, correct?

Larry Glasscock *- Anthem - President, Chairman and CEO*

Exactly. Yes. The other thing that just, again, to reinforce this pricing issue, we are -- we believe, being very, very disciplined, and as we have said many times, we're pricing for the proper margin.

John Rex *- Bear Stearns - Analyst*

And we can assume that 10.5% to 11.5% outlook is the posture you also incorporate in your accrual assumptions also, then; is that correct?

Mike Smith *- Anthem - CFO*

John, it's Mike, and that is absolutely correct. We will not surrender that discipline for a quarter-only observation. Larry has pointed out 10%, again, in the quarter. We take a longer view. One could be tricked into too much optimism, for example, if you reacted to quarter only pharmacy data. We had very low trend rates in the quarter only but remained disciplined to watch the trend over a longer rolling 12 period, so we're sticking to the discipline, staying very focused on pricing to cover trend, and absolutely passionate about not pricing to take share. I've said to you and others many times we have reached scale without surrendering that discipline, and there is no incentive for breaking the discipline in policy.

John Rex *- Bear Stearns - Analyst*

Great. And just a question on your second half guidance, guiding us to $2.62, $2.67 in the second half. Should we assume a similar trend there, slightly up in Q3, a bit more sequentially in Q4.

Mike Smith *- Anthem - CFO*

What we've done today, John, since we're this far into the year we have affirm as Larry did $5.10 to $5.15. I'll give you some color on why the increase in our outlook for the full year, stronger than expected performance just this quarter at 5 cents, improved operating gain outlook in Q3 and Q4 of 12 cents, slightly lower Q3 and Q4 net investment income going the other way then for 3 cents, higher weighted average share count outstanding, therefore impacting EPS by about 4 cents. 5 and 12 plus, 3 and 4 minus, bringing you to approximately 10 up. We see Q3 and Q4 looking pretty similarly so we felt no need to spike out specific guidance for Q3 and would say to you that now at $2.48 against the $5.10 to $5.15 for the balance of the year you can model and expect fairly even distribution over the next two quarters.

John Rex - *Bear Stearns - Analyst*

Great. Thank you.

Operator

Thank you. Our next question comes from is to Scott Fidel with JP Morgan. Please go ahead.

Scott Fidel - *JP Morgan - Analyst*

Good morning. The first question just has to do on the SG&A. Mike, can you spike out some of the specific components you had talked about including the higher incentive, the contribution to the foundations, and the merit increases?

Mike Smith - *Anthem - CFO*

Happy to do so, Scott. Three factors that you have referenced, higher incentive compensation, about $20 million. The contribution to the foundation about $10 million. Higher salaries and wages due both to merit increases and to the extraordinary growth in our National business, up about $10 million. So $40 million of the $58 million sequential increase is tied to those three factors.

Scott Fidel - *JP Morgan - Analyst*

Gotcha.

Mike Smith - *Anthem - CFO*

No other single item of any import.

Scott Fidel - *JP Morgan - Analyst*

Okay. And then on the second question, just on the RX trend which you did see nice improvement there, can you talk about what type of increase in generic scripts as a percentage of total scripts you saw in the quarter relative to last year?

Larry Glasscock - *Anthem - President, Chairman and CEO*

Actually, we really had some very good progress. We now have a generic penetration rate of about 45% of scripts, and if you were to look at the second quarter of '02, that comparable number would have been right around 40%, so very, very significant change there.

Scott Fidel - *JP Morgan - Analyst*

Okay. Great. Thanks.

Operator

Thank you. We now have a question from Bill McKeever with UBS, please go ahead.

Bill McKeever - *UBS - Analyst*

I had a question on the Specialty services. You mentioned the press release here making investments in behavioral health, vision and dental. From 20,000 feet, how long do you think these investments, you'll be investing in that business over the next year, two, three years as sort of a time line for that investment?

Larry Glasscock - *Anthem - President, Chairman and CEO*

Yes. Bill, it will be, you know, over the next few years. We're really pleased with our progress here and we're seeing better increased penetration, so we've had, as I said, in our last call the margin there was under a little pressure given all this investment, but we've had an improvement now in the margin from the first quarter by about 80 basis points, so we're going to continue to invest in in business, and I think, you know, the guidance that I gave you on operating income, I think gives you a very good bench mark of where this is going to go.

Bill McKeever - *UBS - Analyst*

And the follow-up on your PBM, what's the percentage of your membership that are Anthem customers versus outside of Anthem?

Larry Glasscock - *Anthem - President, Chairman and CEO*

The vast, vast majority are Anthem health members. We have relatively modest counts on other third party customers.

Bill McKeever - *UBS - Analyst*

And do you have an intention to grow outside of your Anthem membership?

Larry Glasscock - *Anthem - President, Chairman and CEO*

Yes, we're starting to. Our penetration rate is very high here. Our membership now is about a little over 5 million. And, you know, the biggest, the biggest issue we're working on right now is migrating the PBM members from Trigon over to Anthem prescription management. That will occur around the first of the year. So that's where we're putting all of our energies. We do have some sales efforts which we're beginning to put together to focus on external customers, but we've got a lot to do to continue to grow just by selling it deeper to our various regions.

Bill McKeever *- UBS - Analyst*

All right. Thank you.

Operator

Thank you. And just a reminder, if you have a question, please press star, then 1. We'll now move on to Eric Veiel with Wachovia Securities. Please go ahead.

Eric Veiel *Analyst*

Thank you for the question and thank you for the very detailed breakout on core Anthem versus Trigon. It's very helpful. A couple of quick questions here. Is it possible, Mike, that you can give us an indication of the $150.7 million in favorable development in '02, how much had you received by the six month mark last year?

Mike Smith *- Anthem - CFO*

Eric, the rate at which we are processing claims and therefore are able to recognize those redundancies is actually improved a bit as we complete the systems migration, we're able to shorten the completion cycle slightly, but we believe, frankly, the level of redundancy for the first 6 months is very comparable to last year, notwithstanding those changes in systems, and very consistently conservative, so no reason to believe that we have accelerated the recognition of the redundancy.

Eric Veiel *Analyst*

And just on sort of an order of magnitude base , is it somewhere in the neighborhood of 75% to 85% is recognized by about this period as you've had a decent amount of time to get the tail running through the business?

Mike Smith *- Anthem - CFO*

Absolutely, and, in fact, our data says about 80% of the liability from last year-end would have been completed and therefore considered in the calculation by this time.

Eric Veiel *Analyst*

Great. That's very helpful. And then second question, how should we think about two things on the SG&A line going forward, one would be charitable gifts, and the second incentive compensation for 3Q and 4Q. Is there going to be sort of a sequential $20ish million per quarter assuming the same sort of very strong results?

Mike Smith *- Anthem - CFO*

Let me deal with the first one, Eric. Funding of our foundation is completely discretionary. No specific plans are in place at this time to make any further contributions to the foundation in Q3 or Q4. A little bit of history. The foundation, as you may recall, was set up in 2000, now has about $40 million of assets, and its purpose is to both respond to our philanthropic responsibilities in our communities where United Way has historically been the charity of choice, but also now, and I salute Tom Snead and his team in particular to put emphasis on funding of programs that address access, quality, and affordibilty of health care. Our mission, again, remember, is to improve the health of our members and assure convenience and accordability and quality. The grant made by Southeast in this quarter is earmarked for specific initiatives to give us advantage in the Virginia market. So it will be very strategic in nature and should not be baked into your model as a recurring G&A item. With regard to incentive compensation, again, we've had substantial conversation in the past. This is a three-year plan that will be concluded at the end of '03. The targeted performance measures are income growth over a three-year period, 2001 through 2003 adjusted for performance against peer index and other measures that we think are absolutely perfectly aligned with shareholder interest. I cannot speculate for you what this would look like in subsequent quarters or in '04. That's a matter for the comp committee of our Board and its advisors, but we suspect that our guidance for the full year would certainly not be disrupted by any further change in the '03 rate of expense.

Eric Veiel *Analyst*

Okay. That's helpful. And just a final question, if I may. It looks like just looking at your guidance, if we took sort of the average for the benefit expense ratio in the first two quarters, about 81.45%, looks like you're guiding for that to trend up a little bit in the back half of the year, is that just seasonality as deductibles wear off or is there something else in that?

Mike Smith *- Anthem - CFO*

In part is the math that allows you to take the $31.7 million out of the MLR just arithmetically we're going to end up in the 81.4% to 81.9% range simply reflecting the underlying trend and removing the influence of the prior-year reserve recognition. No anticipated, therefore, margin compression. We think the underlying margins remain about where they are.

Eric Veiel ***Analyst***

Thank you very much.

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Operator

Next question from Christine Arnold with Morgan Stanley. Please go ahead.

Christine Arnold ***- Morgan Stanley - Analyst***

Good morning. A couple of questions. You highlighted the $10 million contribution to your foundation was in SG&A. Where was the other $10 million in initiatives for advancing health care call and affordibility? Was that also in SG&A?

Mike Smith ***- Anthem - CFO***

It was not, Christine. As a matter of fact, it was net in the premium and therefore reflects the slightly lower growth rate in operating revenue. At the end of the day, it's a decision and a recognition by our operators that, due to lower than expected medical cost trends, we have an opportunity to do something very extraordinary, and we think very right, in markets to make specific premium adjustments in very targeted individual lines of business.

Christine Arnold ***- Morgan Stanley - Analyst***

Okay. That explains why the yield in the model looks lower than the 12% you stated.

Mike Smith ***- Anthem - CFO***

Correct.

Christine Arnold ***- Morgan Stanley - Analyst***

Got it. Okay.

Mike Smith ***- Anthem - CFO***

That yield, the 10% versus the 12%, Christine, was influenced in part by that $10.4 million and then also by the change in the mix. Recall, 95% of the growth rate in membership is in ASO.

Christine Arnold ***- Morgan Stanley - Analyst***

Right. Okay. And then the $6 million in increased reserves to provide recovery, I assume that's in the medical loss ratio.

Mike Smith ***- Anthem - CFO***

It's in the admin fee revenue line, and, again, it is a very specific issue. It has to do with a recognition of logic in one of our programs that had us overpay providers when the system assumed that Medicare was primary and, in fact, Medicare was secondary to our coverage. We therefore overpaid the providers and we reflected a valuation reserve against the net recoverable portion of those overpayments, and it was reflected in the admin fee since it deals with our ASO accounts.

Christine Arnold ***- Morgan Stanley - Analyst***

Got it. Okay. So you have a couple of adjustments on a run rate basis to your revenue items.

Mike Smith ***- Anthem - CFO***

Correct.

Christine Arnold ***- Morgan Stanley - Analyst***

And final question, you talked about some of your RFP activity and some of the outlook for a little bit, you touched on, for 2004 but you didn't get into a lot of details. Can you give us some sense for RFP activity, close rates, how much you signed up so far for ‘04 versus a year ago. Any sense on '04 enrollment?

Mike Smith ***- Anthem - CFO***

Sure. Let me -- first of all, we've got, as I remember, we have about 90 RFPs sort of in the house today in our National accounts. That's a very high level and very consistent, Christine, with where we would have been a year ago. So we like the level of activity, and as I mentioned in my remarks, we have already got commitments for the balance of this year and into '04 for 12 accounts. So eight of those accounts are really scheduled either for the third or fourth quarters, and the four remaining then are wins for next year. These accounts are, oh, around, and this is roughly, about 80,000 members. They're all self-insured members. And so we are very pleased with what we're seeing here.

Christine Arnold ***- Morgan Stanley - Analyst***

Okay. That's consistent with kind of what you saw last year in terms of volume.

Mike Smith *- Anthem - CFO*

In terms of RFPs, yes.

Christine Arnold *- Morgan Stanley - Analyst*

And wins.

Mike Smith *- Anthem - CFO*

And wins, yes.

Christine Arnold *- Morgan Stanley - Analyst*

Okay. Perfect. Thank you very much.

Mike Smith *- Anthem - CFO*

I'm not -- I'm not suggesting, you know, as you know, we reported in the first quarter that we had 23 new accounts in National accounts for the first quarter, so I'm not providing guidance that we're going to have 23 for the first quarter of next year, but at least in terms of RFP level of activity, it's about what we would expect, and, you know, our close ratios we're very happy with.

Christine Arnold *- Morgan Stanley - Analyst*

Perfect. Thank you for that color.

Operator

I would now like to turn the conference over to Larry Glasscock for final remarks.

Larry Glasscock *- Anthem - President, Chairman and CEO*

I want to thank everyone very much for participating in this second quarter Earnings Conference Call. We believe very strongly that our results in this quarter were very strong, so we're pleased with our performance and very pleased with the momentum that we see really out there in all of our businesses. So, again, we appreciate your interest in Anthem. I want to take a second, also, and remind you that we have our first investor conference scheduled in Indianapolis on November 18th, so we hope many of you will be there, and so we'll look forward to that opportunity. Have a great day, and, again, thank you for your interest.

Operator

Ladies and gentlemen, this conference will be available for replay after 12:45 p.m. today through midnight, Thursday, August 14. You may access the AT&T executive play back service at any time by dialing 1- 800-475-6701 and entering the access code: 667898. International callers 320-365-3844 using the same access code, 667898. That does conclude our conference for today. Thank you for your participation and for using AT&T . You may now disconnect.