Conference Call Transcript

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PLEASE NOTE: THIS TRANSCRIPT HAS BEEN EDITED FOR ACCURACY

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PRESENTATION

Operator

Good morning, ladies and gentlemen. Thank you for standing by and welcome to the Anthem quarterly earnings results conference call. At this time, all lines are in a listen-only mode. Later, we will conduct a question-and-answer session. Instructions will be given at that time. (OPERATOR INSTRUCTIONS) As a reminder, this conference call is being recorded. I will now turn the conference call over to your host, Vice President of Investor Relations. Ms. Tami Durle.

Tami Durle - ***Anthem, Inc. - VP-IR***

Good morning and welcome to Anthem's third-quarter 2004 earnings conference call. I am Tami Durle, Vice President of Investor Relations, and with me are Larry Glasscock, Anthem's Chairman, President and Chief Executive Officer, and Mike Smith, Chief Financial Officer and President of Anthem National Accounts.

Larry will begin this morning's call with an overview of our third-quarter performance and current events, followed by Mike, who will review our financials. Then Larry will discuss our financial outlook for the rest of 2004 and provide initial guidance for 2005. Larry will also comment on the status of our plans to merge with WellPoint.

We will be making some forward-looking statements on this call. Listeners are cautioned that these statements are subject to certain risks and uncertainties, many of which are difficult to predict and generally beyond the control of Anthem. These risks and uncertainties can cause actual results to differ materially from our current expectations. We advise listeners to review the risk factors discussed in our press release this morning, our Forms 10-Q, and other periodic filings we have made with the SEC. Larry?

Larry Glasscock - ***Anthem, Inc. - Chairman, President, CEO***

Good morning. Anthem's third-quarter performance demonstrates continued strong revenue growth and financial momentum, and was the 13th consecutive quarter since our IPO with earnings meeting or exceeding expectations. We had a very good quarter, with net income increasing by 23 percent to $1.70 per diluted share. Our membership grew by 8 percent and our administrative expense ratio fell to a record low of 16.9 percent. Our cash flow of $410 million in the quarter was also an impressive 1.7 times net income.

The commitment of our associates and their focus on serving our customers have contributed significantly to results that we are able to share with you this morning. It is clear to us that employers and individuals across our regions value Anthem's product offerings, broad network reach, attractive discounts, and distinctive customer service.

We are validating these advantages each quarter with a solid record of new membership growth and retention of existing customers. This track record has resulted in membership that now exceeds 12.7 million members, an increase of 890,000 members since September of last year. Of the new growth, 708,000, or 80 percent, was in administrative services only contracts, where Anthem is not at risk for health benefit costs.

Over the past year, we have achieved membership gains across all four of our regions and each of our key customer segments. National Accounts leads the way in 2004 with 628,000 members, a 14 percent increase over the prior year. Individual and group businesses have also grown significantly. On a sequential basis, we have added over 100,000 members to these customer segments in the last quarter.

As a sign that the economic recovery is underway in our states, in-group growth is continuing to increase. In the first nine months, we have seen 388,000 net additions to our existing groups. Additionally, retention of our membership remained very consistent with our historical experience, which is in the 90 percent range. This retention reflects the strength of our customer service, which gets its focus from our core values and our commitment to excellence.

We also are well-positioned for a good start to 2005, with 24 new committed national accounts. Combined with additional enrollment from existing accounts, we expect our total enrollment to grow by about at least 3 to 4 percent. With growth from BlueCard host membership, we expect to serve at least 13.2 million members in 2005.

We believe that we are staying well-positioned for future membership growth because we are taking an active role in designing and offering products that employers and individuals are asking for. One innovative product that we recently launched addresses the growth in health care costs and the uninsured. Our Anthem-by-Design Health Savings Account, or HSA, offers a high-deductible health plan coupled with a bank account that allows consumers to use checks or debit cards to pay for qualified medical expenses out of their health savings accounts. We are seeing substantial interest in these plans and expect the adoption rate for this product to accelerate in 2005.

This is the latest addition to Anthem's portfolio of consumer-driven health plans that are supported by online tools to help consumers manage their health care decisions. More than 70,000 members are currently enrolled in the Anthem-by-Design portfolio of products. These plans give our members what they have told us they want, affordable products with attractive price points.

Products of this type also encourage uninsured individuals, including the young and healthy, to enter the insurance pool. So far this year, 90,000 of our new individual members came from previously uninsured status. We view the uninsured population as an opportunity for growth, and will continue to develop products to best serve their needs.

The formerly uninsured are not the only members attracted to new developments at Anthem. As we announced earlier this month, Life after 50, our new easy-to-use website developed specifically for members age 50 and older, is designed to help Anthem enrollees become more knowledgeable about their health and services available to them 24 hours a day, seven days a week. Baby boomers and seniors can now access online information and tools tailored specifically for their health and wellness needs.

Technology, as you would expect, is a key driver of this innovation and supports our efforts to become easier to do business with. In August, we were recognized for our innovations in technology by CIO Magazine as a recipient of the 2004 CIO 100 award, which recognizes organizations that exemplify the highest level of operational and strategic excellence in information technology. This year, the award was focused on agility, recognizing organizations that use technology to respond quickly to changing business environments. Winners demonstrate measurable results in how they apply IT to enable and support agility in their organizations.

Anthem was recognized for its speed and flexibility in developing new service models to meet changing customer needs. We were also acknowledged for our innovative approach to implementing key technologies, including e-business, call center technologies, and document management solutions.

With our technology team delivering the right solutions at the right time, we are offering new products and innovative services that improve customer service to our members, hospitals, and physicians, while also reducing administrative costs. Additionally, from an operational perspective, our technology has supported a continued improvement in auto-adjudication and EDI rates. Web-completed transactions, primarily self-service inquiries, also reached 12.1 million thus far in 2004.

I now want to move to our premium and medical cost trends that we are experiencing and projecting. Premium yields remain stable for our fully insured group business at levels sufficient to cover increases in benefit expenses. Medical cost trends were also stable, and we continue to expect overall trends in the 9.5 to 10.5 percent range for the full year.

On the hospital front, we have seen volumes of bed days remain stable, while unit pricing associated with several new contracts has been the driver of the overall increase in inpatient cost. We continue to expand our disease management programs, including programs for specific diseases, such as congestive heart failure, coronary artery disease, and diabetes, as well as our advanced care management programs designed to focus on members with the most acute health challenges. These efforts and many others are demonstrating effectiveness at inpatient cost trends, as they remain in line with expectations.

We are also implementing benefit changes designed to encourage the application of evidence-based medicine principles in the utilization of high-cost inpatient services, such bariatric surgery. We continue to be a market leader in developing quality initiatives with our provider networks. We remain focused on collaborative efforts with physicians and hospitals to develop pay-for-performance incentives, because we believe that higher quality care actually costs less over time. In fact, 46 percent of all of our admissions thus far in 2004 have been in facilities where our contracts include quality incentives.

The cost trends for professional services are about evenly split between unit cost increases and utilization increases. As we have reported over the last several quarters, pharmacy trend is increasing, primarily due to some favorable events, such as Claritin going over the counter in 2003, that are not expected to recur in the current year. Since the impact of these items was already reflected in 2003 costs, trends for 2004 are returning to a higher level, as we expected.

Overall, pharmacy trend is being driven approximately 80 percent by unit cost increases and 20 percent by utilization. We have several strategies in place to address the rising cost of pharmaceuticals. For example, we are modifying pharmacy benefit plan designs to include new co-insurance features and we are continuing to encourage our membership to participate in our Think Generics program. This program educates members about the facts and benefits of using generic drugs, particularly through our mail-order service. The recent removal of Vioxx from the market and some articles questioning the safety of other Cox-2 inhibitors will also potentially have a favorable impact on both the health of our members and our future pharmacy costs.

Outpatient services have been the fastest-growing component of our medical cost, and we are addressing these increases, not only through contracting, but by focusing on those areas that drive cost, particularly ambulatory diagnostic procedures and the growth in imaging procedures, such as MRIs and PET scans. For example, we are rapidly expanding our radiology management program currently in place in the West to our other regions. Our results in the West indicate these programs are effective in reducing utilization trends for radiology services. We recently implemented this program in our East region, and within the first two weeks, preliminary results appear to be very positive. We plan to roll out radiology management programs in our other regions as well.

Other initiatives to address the cost of health care include the expansion of product designs that give consumers greater accountability for managing their health. An example includes higher co-pays for advanced imaging. Additionally, we believe that by expanding our national contracting strategies in areas such as lab services and durable medical equipment, we will be able to reduce the cost of providing outpatient care to our members.

We expect overall cost trends to remain relatively stable for the remainder of 2004 and into 2005, and we are pricing our business for 2005 to reflect these cost expectations. We are very focused and committed to pricing our business with discipline, and are not interested in gaining market share that is not profitable.

I would also point out that our self-funded business, for which we do not take insurance risk, has grown at 10 percent during the first nine months of 2004. However, our fully insured group membership, for which we do take the risk, has grown by 1 percent compared to year-end 2003.

Our top executives and actuaries across the company routinely meet with me to discuss trends and to assure that we are remaining disciplined in our underwriting management practices. After the third-quarter review, I remain confident that we are pricing our business to cover our cost and that we remain on track to accomplish our goals. Our year-to-date gross margin per member per month on fully insured group business continued to increase when compared to the same period last year. This gives us even more confidence in the data we have reviewed.

While there are some occasions where our teams have seen unusual pricing actions by our competitors, by and large, we continue to view the overall pricing environment as generally rational.

I now want to turn to our business practices concerning commissions and bonuses, in light of the recent allegations made against certain P&C brokers and carriers. As you probably saw in press reports last week, the Attorney General of Connecticut planned to issue 35 subpoenas to insurers and brokers doing business in Connecticut. Because we are a major insurer in Connecticut, we are not surprised that we did get a subpoena on Monday of this week, and we are in the process of preparing a response.

Let me emphasize that Anthem operates under a different model than the property and casualty industry. A significant part of our business comes from large national accounts. These accounts typically hire and pay consultants to help evaluate and price their health coverages. In other words, we do not pay consultants for this business.

For local group and individual business, we do pay commissions to licensed insurance brokers who place business with us. These brokers are paid standard commissions and those amounts are part of the premium paid by an employer or subscriber. Our commission rates are included in rate filings with our Departments of Insurance. Commission bonuses are a very small part of our total commission payments, comprising less than two-tenths of a percent of premiums collected annually. Commission bonuses are typically based on persistency and net growth of a broker's entire block of business, not on the profitability or revenue of specific cases.

The allegations regarding bid-rigging and other improper bidding activities are not practices at Anthem. Based upon our investigations to date, we are pleased to say that we have not been asked by brokers to make false or inflated bids. Furthermore, any bid that we have submitted is a genuine attempt to secure business. Results with integrity are a cornerstone of our core values. It has always been and continues to be our intention to operate in full compliance with all rules and regulations concerning commission payments.

Now I would like to turn the call over to Mike Smith, who will discuss our third-quarter financial results in more detail.

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

Thanks, Larry, and good morning. Anthem's third-quarter 2004 net income was $242.1 million, or $1.70 per diluted share on a GAAP basis. This earnings per share growth represented a 23 percent increase year-over-year. Results in both the current quarter and the third quarter of 2003 included 3 cents per share from net realized gains.

We continue to enjoy excellent financial performance in our core operations. Operating revenue exceeded $4.7 billion in the quarter, which was another record for our Company and represented a 13 percent increase year-over-year. All segments of our business reported increase in operating revenue.

Anthem's profitability continue to improve with a consolidated pretax margin of 7.8 percent in the third quarter of 2004, compared to a 7.3 percent pretax margin in last year's third quarter. The year-over-year improvement in profitability was primarily driven by disciplined underwriting, membership gains of 890,000 members over the past 12 months, and administrative expense control, as our administrative expense ratio declined by 180 basis points from last year's third quarter to 16.9 percent this quarter.

In the Midwest, operating gain was $145.3 million in the quarter, a 33 percent increase year-over-year. The results were favorably impacted by $12.7 million in prior-year reserve developments that are not expected to repeat in the fourth quarter. Operating revenue in the Midwest was almost $2 billion in the quarter, a 16 percent increase compared to the third quarter of 2003. Enrollment growth also remained strong, up by 448,000 members, or 8 percent compared to last year.

I would caution you that we do expect to see a sequential decline in Midwest operating gain in the fourth quarter of 2004. This decline will be due, in part, to the prior-year reserve development that I just mentioned, and to additional administrative expenses related to staffing in anticipation of the January enrollment cycle.

In the East, operating gain was $82.3 million, 9 percent above last year's third quarter. The improvement was primarily driven by the strength of results in National Accounts. Results in the quarter were negatively impacted by $4 million in prior year reserve development, as runout relating to 2003 claims was higher than anticipated. Also impacting the results was $4.3 million in severance expenses due to a work force reduction made possible by continued process and productivity improvements.

East's operating revenue increased by 8 percent to almost $1.3 billion in the quarter, in spite of the fourth-quarter 2003 loss of the State of New Hampshire account. Even with this loss of about 30,000 members, net enrollment has increased by 67,000, or 3 percent, when compared to the third quarter of 2003. Our financial momentum has also accelerated in the East region, as evidenced by the 10 percent sequential improvement in operating gain compared to the second quarter.

Now I want to move to our smallest health segment, the West. Our West segment reported a $24.1 million operating gain in the quarter, which was an $8.5 million decrease compared to the third quarter of 2003. This is substantially due to large group, fully insured business, which had benefited from unsustainably high margins in 2003. Operating revenue increased 12 percent year-over-year, reflecting the enrollment gains of 202,000 members over the past 12 months.

In the Southeast, operating revenue reached almost $1.1 billion. Enrollment grew by 173,000 members, or 6 percent, since last September. Operating gain was $94 million in the quarter, resulting in a 15 percent increase over the comparable period last year. Results in the third quarter of 2003 included $30 million in premium refunds to certain policyholders in the Southeast region. Sequentially, the Southeast experienced a $9.5 million decline in operating gain, primarily due to higher benefit expenses. Higher than previously experienced trends in surgeries, radiology, and specialty drugs were the primary drivers.

The specialty segment reported a $19.5 million operating gain in the third quarter of 2004, which is a 4 percent increase year-over-year. Results in this segment were driven by a 44 percent increase in mail-order prescription volume. 27 percent of this increase is related to our Southeast region, which began using the services of Anthem Prescription Management on January 1, 2004.

The operating gain increase for our PBM operation was partially offset by lower operating gains in our smaller specialty businesses. Operating revenue in the specialty segment was $279.1 million in the quarter an $84.9 million, or 44 percent increase, compared to the third quarter of 2003, again driven by increased mail-order sales.

The operating loss in the Other segment was $21 million in the third quarter of 2004. The loss decreased by $17.6 million compared to last year, primarily due to lower incentive compensation expenses following the completion of our 2001 to 2003 long-term incentive measurement period.

Net investment income in the quarter declined by 4 percent, as we were holding $1 billion of cash in lower-yielding, short-term investments in anticipation of our merger with WellPoint. Anthem's consolidated benefit expense ratio was 82.7 percent in the third quarter, 170 basis points higher than the ratio reported a year ago, and in line with our expectations, which remain at 81.5 percent to 82.5 percent for the full year.

Recall that since the first time we provided guidance for 2004, which was during our third quarter 2003 call, we noted that our benefit expense ratio was below a sustainable level and that it would return to more normal levels in 2004. Our administrative expense ratio reached a record low of 16.9 percent in the third quarter of 2004, an improvement of 180 basis points year-over-year.

In fact, in absolute dollars, administrative expenses for the third quarter were up only $17.4 million from the third quarter of last year, an increase of just 2 percent. This is a very low increase considering our 8 percent increase in membership and normal wage inflation. Per member per month administrative expenses also fell 5 percent compared to the prior year. We continue to be pleased with our progress in managing our administrative costs over a larger membership base.

I would also point out that administrative expenses included $5.6 million in severance expenses in the quarter, with the majority of that cost in the East region, as noted earlier.

Now moving to our balance sheet. Cash and investments were $7.9 billion at the end of the quarter, an increase of $568 million from year-end 2003, and total assets have reached approximately $14.1 billion. Our reserves for unpaid life, accident and health claims liability were $1.9 billion at the end of the quarter, an increase of $33 million from year-end 2003.

Days and claims payable in the quarter were 47.2 days, down two days sequentially. Impacting the decline was a further reduction in claims inventory and claims processing time. We saw the time between service and claims payment fall by 3 percent compared with June 30, 2004, while claims inventories have declined by 23 percent during the period.

Our reserve roll-forward schedule, included in today's press release, also demonstrates that we are paying claims at a faster rate, while remaining consistent and conservative in our reserving practices. The amount of claims paid in the current year resulting from claims incurred in the current year has increased from 82.6 percent for the first nine months of 2003 to 83.4 percent for the first nine months of 2004. Hence, payments have been accelerated by approximately $82 million as compared to 2003 payment patterns. The increase is primarily attributable to our systems migrations and improved electronic connectivity with our provider networks. The result is our ability to adjudicate and pay claims more quickly.

Furthermore, our levels of redundancy for the nine months ended September 30, 2004 were $169.9 million, up $34.1 million from June 30, 2004. Redundancies as a percentage of prior-year claims were 1.4 percent compared to 1.6 percent for the nine months ended September 30, 2003 on a same-store basis.

Finally, as Larry has indicated, we had very strong cash flow from operations at $409.6 million, or 1.7 times net income, in the third quarter. During the quarter, we repurchased 1 million Anthem shares for approximately $82.2 million, at an average price of $82.24 per share. Our Board has also increased our authorization to repurchase shares by an additional $500 million through February 2006, and we intend to continue to aggressively buy back our shares. This reflects our confidence in the future of our business, recognizes our stock's relative valuation, and is an effective use of our capital to enhance shareholder value.

Now here is Larry, who will provide our updated earnings guidance for the rest of the year and provide initial guidance for 2005.

Larry Glasscock - *Anthem, Inc. - Chairman, President, CEO*

Thanks, Mike. Keep in mind that our earnings guidance is for Anthem only and does not include any expectations for WellPoint, nor does it include any additional net realized investment gains or losses.

We are now projecting GAAP net income of $7.05 to $7.10 per diluted share for 2004, which represents an increase from our previous guidance of $6.95 to $7.05 per share. This includes 31 cents per share in tax benefits associated with a change in Indiana laws governing the state's high-risk health insurance pool that we reported in the first quarter, and 19 cents per share in realized investment gains.

The operating revenue growth rate for 2004 is expected to be about 12 percent, with membership growth for the year of approximately 7 percent. We will continue to remain disciplined in pricing our business to cover medical costs and we expect cost trends to be in the 9.5 to 10.5 percent range this year, consistent with our previous guidance. The benefit expense ratio for the current year will be near the higher end of our prior 81.5 to 82.5 percent guidance range. The administrative expense ratio is projected to be near the lower end of our prior 17.4 percent to 17.9 percent range.

Looking ahead to 2005, we are projecting net income of at least $7.60 per share, and we expect cost trends to be relatively stable with current levels. Additional guidance for 2005 will be provided on our fourth-quarter conference call, after our Board has approved our plans for next year.

I now want to turn to our pending merger with WellPoint, which was announced, coincidentally, one year ago today. In addition to the lawsuit we filed on August 4 of 2004, we continue to evaluate all options available to us to complete this transaction. We remain committed to the merger and will work diligently towards completing it.

Since the announcement of our plan to merge, integration teams have completed very substantial planning efforts. Over 300 initiatives have been identified to achieve our targeted improvements in service and cost savings, and we are well positioned to implement these upon consummation of the merger. That said, we have also sent a very clear message throughout our organization that our first priority is to focus on customers and normal business operations, and not to be distracted by the status of the merger.

Now, what I would like to do is open the call up for questions.

QUESTION AND ANSWER

Operator

(OPERATOR INSTRUCTIONS) Charles Boorady from Smith Barney.

Charles Boorady *- Smith Barney - Analyst*

Thanks. Good morning. My first question on the days claims payable, and thanks so much for giving us the clarity on the change from date of service to date of payment. That kind of helps close the loop. I just want to make sure I understood the 3 percent drop number that you mentioned from June '04. Do I think of that as responsible for a 3 percent drop in days claims payable, or about 1 point for days impact in days claims payable? And also, the 23 percent drop in inventory, can you quantify that in terms of days claims payable impact?

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

Charles, thank you. Yes, I will. At June 30, '04, we reported 49.2 days in claims payable. We have acknowledged an increase in the speed of payment of incurred claims, which we believe is accountable for 1.5 of the days reduction. And the reduction in our inventories has an impact of about 2.3 days. Offsetting that is the increase in the IBNR that I reported, taking us back up by 1.8 days to the 47.2 days that I've reported. So speed at 1.5 days improvement, reduction in inventories at 2.3 days, offset by increased reserves for incurred but not yet reported liabilities of 1.8 days.

Charles Boorady *- Smith Barney - Analyst*

Excellent. Thanks for spelling that out again. And my follow-up question is on the premium yield that was higher than what I had modeled and was surprisingly higher sequentially, given that third quarter is not a big renewal period. Can you give us more color on that in terms of what percent of the risk business renewed in the quarter and what the average renewal increases were for premiums?

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

Charles, we have reported that premium yields were strong and disciplined, as expected. We continue, as you know, to focus on pricing to the cover trends. And we believe that with about 25 percent of our risk business renewing in the quarter, we are now expressing and validating the discipline in the pricing, as the yield is holding, as we had previously guided.

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

Okay, thanks.

Operator

Josh Raskin from Lehman Brothers.

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

Good morning. One quick just clarification. The prior-period reserve, I think, net was reported at 8.7 million. But if I looked at the redundancies in the six months through June 30 and I compare that to the nine-month total, I'm getting a $34 million increase in that number. Mike, I was wondering if you could help us understand that. And then just a quick question on the merger. Is there any way to quantify the total amount of cost in SG&A this year related to, as you said, a lot of the progress that was made by the integration teams?

Mike Smith - ***Anthem, Inc. - CFO, President-Anthem National Accounts***

Of the cost savings, Josh, may I get clarification on the last part of your question?

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

Not the savings, I'm sorry, Mike. The actual dollars spent in terms of merger-related activities.

Mike Smith - ***Anthem, Inc. - CFO, President-Anthem National Accounts***

Yes. And you'll find a disclosure in the 10-Q, which we will be filing if not today, tomorrow. We have incurred about $18.6 million of cost related to the merger. And as you know, in the case of the acquiring company, GAAP accounting provides for the deferral of those expenses until the merger is completed. And hence, the earnings of the Company have not been adversely impacted by costs associated with the pending merger.

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

Okay, and then the prior period reserve development --?

Mike Smith - ***Anthem, Inc. - CFO, President-Anthem National Accounts***

Right. Your correlation of the prior-period reserve development to the roll-forward schedule begs for a fair amount of discussion. Prior-period redundancies, which we have disclosed consistently throughout our public reporting days, relate specifically to cells or claims where we know that the prior period was inordinately over reserved beyond our provision for adverse deviation.

The releases or the recognition of redundancies disclosed in the roll-forward table is a much more macro acknowledgment, as the triangles are refined and trued-up in the period subsequent to the balance sheet date. So the acknowledgment of the 12.7 million in the Midwest is a specific recognition of certain blocks of business that we now know had additional reserve at year-end, not required as those claims have run out.

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

Okay, so we should think of this PPRD as the amount that you report as a more specific number, whereas the roll-forward schedule, it sounds like that is, as you said, a macro approach. So the difference is not just simply what relates to the current year redundancies?

Mike Smith - ***Anthem, Inc. - CFO, President-Anthem National Accounts***

I think the better defining difference, Josh, is that for that $12.7 million, we know that in that particular cell of business there is not a need to restore a provision for adverse deviation. That is, we have had sufficient completion to know that no restoration with regard to that specific cell of business is required.

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

Got it. Okay, thanks. I'll get back in queue.

Operator

John Rex from Bear Stearns.

John Rex - ***Bear Stearns - Analyst***

Good morning. First question, in your press release, you comment that you are now comfortable that your medical cost ratio is at more sustainable levels. And should we read that to indicate that you would view that this is a level of MCR that you can sustain in '05, and obviously this relates to your pricing stance against cost trend.

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

We absolutely believe that that is an accurate description, and I return you to the several comments Larry has made during his presentation and I as well. We disclosed in the third quarter call in 2003 that the MLR ratios were not at sustainable levels. We gave dramatic transparency around operating gain ratios and MLRs in the West and Southeast, announced activities that were initiated in the Southeast to restore a proper alignment of prices to cost trends, and we have, just as we predicted at that time, now acknowledged that our MLR and cost trends have restored us to more normal levels.

We further said that the MLR levels that we are observing should remain relatively stable for the balance of the year and into 2005.

John Rex *- Bear Stearns - Analyst*

So if I break it down to the straight math we calculate off the income statements, percentage cost trend and percentage premium yield should be essentially equivalent in '05?

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

That is a fair analysis.

John Rex *- Bear Stearns - Analyst*

Then just to follow on, in the past, you've provided your rolling 12-month cost and premium yields with the component trends. Can you provide those for us again?

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

We are very specific in our guidance regarding the 9.5 to 10.5 percent trend, and believe that that is an appropriate guidance to point you to for the full year. I'll give it to you as we have done in the past, Josh, by bucket. Inpatient trends, we continue to expect a 9 to 10 percent range for full year 2004. Outpatient trends we expect to be between 11 and 12 percent. Professional fees are expected to trend between 8.5 and 9.5 percent. And pharmacy trends are expected to be between 10.5 and 11.5 percent. All-in, giving appropriate weight to each of those components of medical cost, we expect a 9.5 to 10.5 percent trend.

John Rex *- Bear Stearns - Analyst*

But no update on the actual 12-month rolling? Like last quarter, it was (ph) 10 percent on the med cost trend on the 12-month rolling.

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

The update, again, as Larry and I have shared with you, is that we remain relatively stable with the rolling 12 months that we provided in the second-quarter call.

John Rex *- Bear Stearns - Analyst*

Great. That is very helpful. Thank you.

Operator

Bill McKeever from UBS.

Bill McKeever *- UBS Warburg - Analyst*

Yes, on the SG&A side, you consolidated your platforms to one platform in each of the regions, and I believe you completed that a while ago. I'm just wondering, you are obviously seeing improvements in your SG&A ratio. How long does that improvement to or consolidation to one platform, how long does that continue to benefit the SG&A?

Larry Glasscock *- Anthem, Inc. - Chairman, President, CEO*

Bill, we think, as we have said, I think, before as we have had these calls, there is more runway left to reduce our administrative costs. The thing that we are very pleased with and which some lose sight of is we have actually migrated about 4 million members to systems of choice over the last several years. And as we continue to -- we believe we're going to continue to get the benefit of that consolidation effort. So we believe -- we're really proud of the fact that if you look at our, as Mike said earlier, our PMPM cost, we're going to be down 5 percent. So, more runway left. I think we have said in the past that for '04, for example, we get maybe 100 to 150 basis points, and we are certainly going to be well within that range.

And then our long-term model that we have spoken about before on these calls is that we're going to get, as I said earlier, ongoing administrative expense improvement. I think ultimately, as we have said before, we think we can get into the low teens. And if you were to include premium and premium equivalents, we would be probably high single digits. So again, I think that will demonstrate pretty substantial improvement.

Bill McKeever *- UBS Warburg - Analyst*

Okay, great. And then just philosophically -- it is not really related, but I will take it as a follow-up anyway -- on the benefit buydowns, do you assume, as you look into your cost trends, that the benefit buydowns that are implemented for '05, that they affect utilization or consumption of health care?

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

Yes, Bill. Of course. We believe that, in fact, that is the essence of a plan sponsor and a health benefits company, putting that designing into the calculus, the economics. We intend to encourage the right behavior and want our members get the right care at the right time and the right setting, but specific buydowns are intended to guide that level. We have reported that we're seeing about 190 basis points of buydowns through the third quarter of '04. We expect buydowns for the full year at about 200 basis points. That is lower than the buydowns that we talked about in '03, which were at about 250 basis points. But we don't -- in terms of pricing, we continue to price to cover our expected net plan paid benefits, net of any impact that the buydowns would have on consumption.

Bill McKeever *- UBS Warburg - Analyst*

Okay, great. Thank you.

Operator

Doug Simpson from Merrill Lynch.

Doug Simpson *- Merrill Lynch - Analyst*

Good morning. I was just wondering to maybe get a little bit of color. If we use something like 143 million shares with the $7.60 number for '05, gets you about 1.1 billion in net income. Just wondering how do you think directionally about operating cash flow relative to net income in '05 and where do you see CapEx?

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

Doug, we would expect cash flow related to net income in '05 to correlate pretty closely to '04 guidance, because frankly, we're not predicting any dramatic change in the mix of business, risk versus ASO. And CapEx in '05 will, as it has been in the past several years, be principally related to IT items at about $95 million.

Doug Simpson *- Merrill Lynch - Analyst*

I apologize -- I should probably have this at my fingertips -- but could you just refresh me your guidance for '04 on full-year cash flow?

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

About $1.1 billion.

Doug Simpson *- Merrill Lynch - Analyst*

Okay, great. Thank you.

Operator

Eric Veiel from Wachovia.

Eric Veiel *- Wachovia - Analyst*

Yes, just to follow up on Doug's question. I'm not sure I understood the answer. '05 absolute dollar basis flat in cash flow from operations or just as a proportion of net income?

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

No, Eric, similar in its relationship to net income.

Eric Veiel *- Wachovia - Analyst*

Okay. That's what I thought too.

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

Growing in line with net income, but no dramatic change in the dynamic because we do not expect a dramatic change in the mix.

Eric Veiel *- Wachovia - Analyst*

That's what I thought. Follow-up on the Southeast region, I guess where you saw a little bit higher medical cost in a couple of components. Have you been able to go back and analyze whether that was -- was it a selection issue, demographics, something like that, that drove the increase in costs, or what was behind that increase?

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

We have not at this point parsed it out by health demographics of the risk pool. We would rather say it is a general trend, driven more by clinical service patterns than by a change in the demographics of our risk pool. And as we said, spiked out largely in utilization of surgical procedures, radiological diagnostic procedures, and specialty pharmacy. But no observed change in the mix of our risk pool.

Eric Veiel *- Wachovia - Analyst*

And are those clinical service patterns, Mike, that you think are particular to the practice patterns of physicians in Virginia, or is this something that might be something to think about for other geographies?

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

We have observed before that both the strength of the Company and the challenge of the Company is that health care is very much a local economy. And health service is delivered differently in each of our geographies, and therefore, again as a region, we spike out these trends regionally, indicating that they are unique, in this case to the Southeast.

Larry Glasscock *- Anthem, Inc. - Chairman, President, CEO*

One area -- just to add to that if I may, one area that I did spike out for you in my comments had to do with radiology. And certainly, some of the experience around radiology has been across the regions, and that is why we are rolling out the program that I mentioned earlier.

Eric Veiel *- Wachovia - Analyst*

That is helpful, Larry, and the radiology comment is consistent with some of what your peers have been saying as well. Thank you.

Operator

Matthew Borsch from Goldman Sachs.

Matthew Borsch *- Goldman Sachs - Analyst*

Good morning. Just on a related question, could you just tell us -- if you could characterize the 4 million in unfavorable developments, I believe you had in the East region in the quarter from 2003. Did that relate to aftermath of the flu season?

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

Matt, it did not relate to the aftermath of the flu season. The East reserve strengthening related to an adjustment to the Connecticut small employer health reinsurance pool, very specific to a state-administered program. Claims run out were higher than expected for that group. We are required to participate in that program, and we strengthened our reserves specifically to that customer segment. It had nothing to do with a specific health trend or disease state or anything systemic to the East book; very specific to a small part of our insured population -- in this case, small employer health reinsurance pool.

Matthew Borsch *- Goldman Sachs - Analyst*

Got it. And you had talked about the level of buydowns that you are seeing for this year. Can give us a sense of what you think it is going to be for '05 relative to '04, and what the appetite of your customers is generally for higher buydowns going into next year?

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

We would confirm what is being published widely, that employers are giving strong indication of stable levels of buydown, no dramatic indication of further buydowns in '05.

Matthew Borsch *- Goldman Sachs - Analyst*

Great. And last one, if I could, just in terms of the preference for funding self-insured versus fully insured, are you seeing a continuation of a gradual trend towards self-insuring in your markets?

Larry Glasscock *- Anthem, Inc. - Chairman, President, CEO*

What we're seeing is that, as I mentioned earlier, we are growing our book very much in the ASO lines. Mike now runs, as you know, the National Accounts as part of his responsibilities, and that National book of business is growing very rapidly. So that self-funded membership is now up to about 56 percent of our total membership.

We have seen relatively modest conversions really within our existing book. So, for example, people moving from fully insured to ASO, if you look at the last year, I think that number is about 70,000 to 71,000 members. So this is really being driven by the fact that we have a lot of customers very interested in our value proposition across the Company, but certainly in the National Accounts arena.

Matthew Borsch - *Goldman Sachs - Analyst*

Great, thank you.

Operator

Patrick Hojlo from CSFB.

Patrick Hojlo - *Credit Suisse First Boston - Analyst*

Good morning. Could you give us a little more detail on the internal review you have done to date that makes you comfortable with your comments about the fact that you have not ever seen or heard of any hints of activity that may be against Company policy within your ranks?

Larry Glasscock - *Anthem, Inc. - Chairman, President, CEO*

We have had a very extensive set of discussions with people in the sales and underwriting areas. And as a result of that, I'm convinced, based on all of the information that we have seen to date, that we can be very proud of our practices. So obviously, as this continues to go on, we will do more work along the way, but I feel very good about where we are.

Patrick Hojlo - *Credit Suisse First Boston - Analyst*

Fair enough. Now, the membership guidance for '05 number that you gave, just want to clarify. That's for the full year '05, or is that for new members as of January 1?

Larry Glasscock - *Anthem, Inc. - Chairman, President, CEO*

The membership growth that I gave you would be for the full year.

Patrick Hojlo - *Credit Suisse First Boston - Analyst*

Okay. And one last quick one. Any more severance charges or severance costs expected in the East region this quarter?

Larry Glasscock - *Anthem, Inc. - Chairman, President, CEO*

None.

Patrick Hojlo - *Credit Suisse First Boston - Analyst*

Great, thanks a lot.

Operator

Tom Carroll from Legg Mason.

Tom Carroll - *Legg Mason - Analyst*

Good morning. Given the growth in your national business, what are you seeing as the average size of any given national account right now?

Mike Smith - *Anthem, Inc. - CFO, President-Anthem National Accounts*

Tom, thank you. Size is increasing per case. In fact, as we reported, 24 new cases. The complexion of those cases is changing. Recall last year we talked about new cases in the 30s. This year, fewer, larger cases, so we are seeing much more interest on the part of employers and plan sponsors of substantially larger cases. Our focus is at 5000 and above. We continue to grow. Of the cases referenced, we still are obviously delighted to add new clients below 5000, but I would tell you that the preponderance of the pipeline is 5000 and up.

Tom Carroll - *Legg Mason - Analyst*

Any average though? Is it 10,000, 12,000?

Mike Smith - *Anthem, Inc. - CFO, President-Anthem National Accounts*

We don't report or disclose that data, Tom.

Tom Carroll - *Legg Mason - Analyst*

One last comment. Do you expect to be active, an active repurchaser of your own stock here near-term, given the pullback in the valuation?

Larry Glasscock - *Anthem, Inc. - Chairman, President, CEO*

Very specific answer that we have to give you. As soon as possible. However, I want to make very clear to everybody, typically we begin repurchasing shares two days after our earnings release. In this period, we will be limited to our repurchase launch date by the fact that on November 15, we will be settling the issuance of shares to the equity security holders, who will mandatorily convert their interest to about 5.2 million new shares issued. We continue to understand that I believe it is Reg M that precludes us from buying shares back when we are in the middle of an issuance or distribution. So in our case, we may need to wait until November 15.

Tom Carroll *- Legg Mason - Analyst*

Very good, that's helpful. Thank you.

Operator

Scott Fidel from JP Morgan.

Scott Fidel *- JP Morgan - Analyst*

Thanks. Good morning. First question just has to do with the enrollment guidance for next year. What are your assumptions in terms of the economic environment, and just in group growth or attrition? It looks like it's improving here. Are you assuming essentially stable levels there?

Larry Glasscock *- Anthem, Inc. - Chairman, President, CEO*

We are. As we think about this, and obviously as we get further into the cycle here, we will update the guidance. But we are seeing an economy that, in our view at least for our planning assumptions, continues to move along at about the pace it is, so we're not seeing a significant difference there. We think we will get some in-group enrollment growth. It has been very high this year. But I can't really be more specific than that at this stage.

But the thing I would also add that we not forget is if we get this 4 percent organic growth in '05, that is going to give us another roughly a 0.5 million members. So we think that is very good growth considering where we stand in the economic cycle and so forth.

Scott Fidel *- JP Morgan - Analyst*

Right. And then just a follow-up question on that. It certainly looks -- the SG&A improvements have been substantial here over the last year or so. In thinking about those, one area, the BlueCard, has certainly seen a lot of good growth, so there is probably an assumption that the operating leverage and efficiencies you are seeing in that program at this point is pretty substantial. Can you talk about how much of the SG&A improvements are coming from improved efficiency in BlueCard, relative to the productivity enhancements you're seeing from your systems conversion and just general operating improvements?

Larry Glasscock *- Anthem, Inc. - Chairman, President, CEO*

Let me -- and I will let Mike add, since he runs National too -- but first of all on the issue of admin cost itself, you indicated that we really had some pretty significant improvement there in the last year or so. I would remind everybody that in 1998, our admin expense ratio was 26.3 percent. So we have really had a very, very sustained effort to work that number down. The BlueCard aspect of it is not a big driver of cost. I will let Mike comment on that further, but that is not a big element of this.

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

Scott, I should thank you for teeing the boss up to acknowledge that. Let me assure you, the same pursuit of efficiency goes on in our host BlueCard operations as Anthem embraces across its entire enterprise. My challenge to our associates and our National Accounts unit is to hold PMPM costs at least flat, and hopefully, as you acknowledge, secure the leverage that we should be able to capture as that BlueCard host business grows. So we have every intention of widening the margin in the BlueCard host business on the strength of leverage of our production shops.

Scott Fidel *- JP Morgan - Analyst*

Okay. And also, could you update us on where your auto-adjudication and EDI rates stand at this point?

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

Sure. Our auto-adjudication rates do vary somewhat by region, but on an enterprisewide basis, we are at approximately 80 percent auto-adjudication rates. 70 percent of our claims are received electronically. The auto-adjudication rate that I have quoted includes both those claims that come to us via EDI and from the auto-adjudication of paper claims that we receive after we have scanned them into our systems. We know obviously that the auto-adjudication rate improves efficiency and accuracy, and most importantly, drives the G&A leverage that you have just referred to. So we have every intention of continuing to take them higher. We're very pleased, frankly, that we are getting to an 80 percent level, but have every expectation to press on and move that even higher. It is the best service to our providers.

Larry Glasscock *- Anthem, Inc. - Chairman, President, CEO*

I think if you look at that auto-adjudication rate for our enterprise, it has got to be at the top end of what's going on in the industry.

Scott Fidel *- JP Morgan - Analyst*

Okay, great. Thank you.

Operator

Ed Kroll from S.G. Cowen.

Ed Kroll - *SG Cowen - Analyst*

Good morning. On the medical loss ratio, looking at this quarter either year-over-year or sequentially, the increase, is that -- just want you to give us some color on that. Is that a function of mix shift, product mix shift, geographic mix shift, or is the medical cost trend, let's say, at the higher end of that 9.5 to 10.5 percent guidance range, and maybe the yield is at the lower and? I just want some color on that change in the medical loss ratio.

Mike Smith - *Anthem, Inc. - CFO, President-Anthem National Accounts*

You have basically recited every factor as you asked the question. Yes, it is a function of mix change. It is also a function of our own discipline in pricing our business. It is a deliberate, intentional effort to competitively take advantage of our administrative expense leverage and to keep our products appropriately priced to secure our current leading market shares and to deliver to our customers the best value available to them in the market. This is all about value-based marketing and selling. We want, of course, to capture the full value of our networks, their reach, their value, and also sustain our competitive advantage by taking full advantage of the progress that we are making in reducing our administrative expenses.

Now we also have to acknowledge that Anthem operates a very large portion of the Blue system FEP operation and we do see some influence of mix change as FEP design and enrollment increases.

Ed Kroll - *SG Cowen - Analyst*

I'm sorry, what's FEP?

Mike Smith - *Anthem, Inc. - CFO, President-Anthem National Accounts*

Federal employee program.

Ed Kroll - *SG Cowen - Analyst*

Okay.

Mike Smith - *Anthem, Inc. - CFO, President-Anthem National Accounts*

I could just spike this out further. Without FEP, Anthem's medical loss ratio for the nine months ended September 30, 2004 would have been at approximately 80.3 percent. I know many of you like to make comparative analyses of where our net loss ratio is among other publicly reporting companies, but recall with a very substantial FEP enrollment of over 700,000 members in our book of business as a part of our 5.6 million fully insured lives, that net loss ratio is impacted by FEP.

Ed Kroll - *SG Cowen - Analyst*

Very good. Thank you, Mike.

Operator

Our final question today comes from the line of Lee Cooperman from Omega Advisors.

Lee Cooperman - *Omega Advisors - Analyst*

Good morning. It's all financial related. Could you discuss the following? Cash at the holding company level. Two, of the typical $1 billion or so of cash flow that you are generating, typically how much of that are you giving up to the holding company? Third, does your guidance assume the repurchase of the shares or is the guidance independent of that? Lastly, if you could discuss this 5.2 million shares that you're issuing, is that already in 139 million share count or is that in addition to the 139 million shares?

Mike Smith - *Anthem, Inc. - CFO, President-Anthem National Accounts*

I'm going to take them in reverse order, Lee, and thank you for all the questions. The dilutive impact of the shares that are being issued has already been given full effect in the reported fully-diluted shares throughout '04, so there is no further dilutive impact from those shares that will be issued.

Now let me go back up to the top. We are holding about $1.1 billion in cash and short-term investments at the parent company. We have dividended this year from our regulated subsidiaries about $440 million in ordinary dividends from the regulated insurance subs up to the ultimate parent. Recall all of you our structure. Immediately below Anthem Inc. is a holding company, Anthem Insurance Companies Inc. And the stacking of that arrangement, Anthem Insurance Company Inc. then in turn has several regulated subsidiaries.

So the process of securing to the ultimate parent the cash flow of its regulated subsidiaries is actually delayed by two cycles. Earnings of the subs in '03 were dividended to AICI in '04, that creates its dividendable income, which will be paid up to Inc. in the spring of '05. So as you compare cash flow of the Company to free cash flow at its parent, remember there is a delay and that the amount of dividends that are able to be paid up from the subs is a function of stat income -- statutory income, not GAAP income.

Lee Cooperman *- Omega Advisors - Analyst*

So a typical year, what would you get? Is the 440 typical or is that only for nine months and there will be additional payment?

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

No. And Lee, we've had this conversation with broad audiences before, and I have pointed you to the fact that as GAAP income is growing in the 20s, it is not a misleading indicator for you to assume that cash flow from the subs in a current period may approximate 75 percent of reported GAAP income. That delay means, in fact, I am paying the old earnings up in the current year.

Lee Cooperman *- Omega Advisors - Analyst*

Got you. And the last piece, does your guidance assume that you repurchase the authorization, or is that on --?

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

Our guidance for the balance of '04 --.

Lee Cooperman *- Omega Advisors - Analyst*

Next year's guidance.

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

Yes. Lee, the '05 growth in earnings is not inclusive of any anticipated use of the now $700 million. So in other words, we have used a static outstanding number of fully-diluted shares to get to the growth in EPS for next year. No lift from the use of the full authorization.

Lee Cooperman *- Omega Advisors - Analyst*

Assuming you guys are logical, and we paid $82.24 per share in the third quarter, and the business is doing better than it was doing, I would assume that that will be an add-on that hopefully we all can look forward to in '05.

Mike Smith *- Anthem, Inc. - CFO, President-Anthem National Accounts*

That is not an unreasonable assumption.

Lee Cooperman *- Omega Advisors - Analyst*

Thank you and good luck.

Operator

Ladies and gentlemen, that concludes our question-and-answer session for today. I will turn the conference back over to Larry Glasscock for closing remarks.

Larry Glasscock *- Anthem, Inc. - Chairman, President, CEO*

Thank you. In closing, I just want reiterate our optimism about Anthem's future on a stand-alone basis or in combination with WellPoint. Our fundamentals remain very strong and we remain confident in our ability to deliver on our long-term goal of earnings per share growth of at least 15 percent.

We will accomplish this through profitable enrollment increases, making sure that we effectively manage our administrative expenses, and then also making sure that we maintain our margins with discipline. I feel very strongly that we have the right products, the right people, and the unique strengths to really secure our place as a leader in the health benefits industry. I want to thank all of you for your questions and your interest this morning and I hope each and every one of you has a great day.

Operator

Ladies and gentlemen, this conference is available for replay that begins today at 1:45 PM Eastern time through November 10 at midnight. To access the AT&T Executive Replay Service, dial 1-800-475-6701. The access code, 691033. International parties may call 320-365-3844. (OPERATOR INSTRUCTIONS) That concludes your conference for today. Thank you for your participation and using AT&T Executive Teleconference. You may now disconnect.

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