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HMSY - Q3 2014 HMS Holdings Corp Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the HMS Q3 2014 Earnings call.

(Operator Instructions)

As a reminder, this conference call is being recorded. I would now like to introduce your host for today's conference, Mr. Dennis Oakes, Senior Vice President Investor Relations. Sir, you may begin.

Dennis Oakes - *HMS Holdings Corporation - SVP of IR*

Thank you, Crystal. Good morning, and thank you for joining us for the HMS third-quarter earnings conference call. With me today are Bill Lucia, our President and Chief Executive Officer, and Jeff Sherman, our Chief Financial Officer.

As you know, we distribute our Earnings Release through our website HMS.com under the Investor Relations tab. Though we will not make specifics reference to them on the call this morning, we also posted our usual quarterly investor slides containing supplemental information. This call is being webcast and can be accessed by the Events and Presentations tab on our Investor Relations site, and a replay of the call will be posted later this morning.

Let me remind you that some of the information presented today regarding the Company's future expectations, plans and prospects is considered forward-looking statements under the Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995. These statements are based on the Company's current expectations, and actual events may differ materially from those expectations.

We refer you to the Company's filings with the Securities and Exchange Commission including our annual report on Form 10-K, and our quarterly reports on Form 10-Q. Which identify important risk factors that could cause actual results to differ materially from those contained in the Company's projections or forward-looking statements. All information on this call is as of today, November 4, 2014, and the Company disclaims any intent or obligation to update any forward-looking statements as a result of developments occurring after today's call.

During this call, we will be referring to certain non-GAAP measures. The press release issued this morning includes a reconciliation of those measures to GAAP.

We're now ready to begin. Bill?

Bill Lucia - *HMS Holdings Corporation - President & CEO*

Thank you, Dennis, and good morning.

Our third-quarter results reflect five important trends that have been building over the course of this year. First, is the significant increase in new Medicaid lives added to our existing client's eligibility files. Second, is strength in our state government business, despite the fact that most new Medicaid enrollees enter managed care.

Third, is the rebound and coordination of benefits revenue which began last quarter. Fourth, is the ongoing progress in taking costs out of our business. And fifth, is continued sales traction in the commercial market.

HMS has been a significant beneficiary of the ACA. The ACA driven Medicaid expansion over the first nine months of this year we added approximately 7.9 million new Medicaid lives to our customer database. Based on the most recent monthly report from CMS, which captures data through August, approximately 8.7 million individuals have enrolled in Medicaid since October 2013.

October was the beginning of marketplace open enrollment, and is the CMS baseline for measuring expansion. Our internal eligibility warehouse is coming closer into alignment with the public numbers released by CMS. So by early next year, we expect our client eligibility files to roughly track the CMS tally for full year 2014.

The recent Kaiser Family Foundation annual survey of state Medicaid directors and the CMS office of the actuary both project incremental enrollment growth of approximately 5% in 2015. Which is good news for our state and commercial market growth prospects.

When we provided our outlook for 2014 last February, we expected state government market revenue this year would be flat, or up in the low single digits. We have seen greater than anticipated year-to-date improvement, however, which suggests full year growth more in the 6% to 8% range.

Despite the predominance of new Medicaid enrollees entering managed care versus fee for service, we are still benefiting from Medicaid expansion in our state government business. In addition, we had sales activity in the quarter that included new procurements, product expansions, and contract extensions with existing customers in five states.

Our state contracts typically have 3 to 5 year terms, and the number expiring annually varies quite a bit. For example, 2014 was a reasonably light year for reprocurement of existing state contracts, while 2015 is a big year for us.

A dozen of our state contracts, which represent a significant portion of 2014's state revenue are scheduled for rebid during the year. As always, we expect those procurements to be competitive, which will likely include increased pricing pressure. But we are well positioned to submit strong proposals, based on our extensive experience and service to our state government clients.

As is well understood by those who follow our business closely, our two largest state contracts, New York and New Jersey, are among the anticipated competitive bids in 2015, though neither of the RFPs has been issued. Our New Jersey contract was scheduled to expire on October 31st, but the state recently extended it through April 30th of next year. We therefore expect the New Jersey RFP will be issued in the next few months.

In New York, our contract has an optional one year extension that runs from January of 2015 through January 2016. Historically, states generally exercise such options. If New York does so, we would not expect their RFP to be released until the Fall of next year.

A third very encouraging area of progress this quarter is continued growth in our COB product revenue. Prior to the second quarter of this year, we experienced several quarters where COB revenue was flat to down compared to the corresponding prior-year quarters. COB revenue increased substantially this quarter compared to the prior-year third quarter.

The growth we achieved in both the second and the third quarters is related to Medicaid expansion, and the resulting enrollment increase in our customer data. But also reflects our ongoing focus on product yield improvements. We have added engineers and product specialists to enhance yield, which continues to be a meaningful contributor to our overall growth.

The fourth point I want to highlight is the operating cost leverage we are achieving. Process improvement initiatives drove operating expenses down approximately $6 million or 6% from the prior-year third quarter.

And through the first nine months of this year, we reduced overall operating expense by approximately $13.5 million, excluding a $3 million decline in amortization. We believe additional expense could be taken out across the enterprise, so cost saving initiatives remain an ongoing focus as we plan for the year ahead.

The fifth important aspect of our third-quarter performance which has been evident throughout the year is significant growth in our commercial market. That growth is coming from the sale of products to new commercial customers, as well as expanded product penetration within our existing customer base. Since the beginning of the year, we have added approximately 7.9 million new commercial lives to our customer base, including approximately 1.8 million this past quarter.

We continue to pursue opportunities to make sales to new customers, but we are also intensely focused on increasing product penetration and continue to make good progress in that regard. Through the first three quarters of this year, we sold additional products to current commercial customers that will be rolled out across approximately 10.6 million of their members.

Our overall commercial success this quarter is reflected in the 18% year-over-year increase for commercial revenue. Though impressive, that increase and our full-year projection for commercial revenue growth are shy of our expectations when the year began, primarily as a result of lagging program integrity revenue.

Essentially, though we have had the success we anticipated with new commercial program integrity sales, unexpected implementation delays you due primarily to customer scheduling considerations have deferred their revenue impact. Our commercial market success so far this year is due to a heightened focus on market opportunities, as well as industry dynamics that continue to move in our favor.

Our commercial revenue growth has been accomplished, however, without the benefit of the planned expansion of our commercial sales force, which is just coming together as the fourth quarter begins. We hope to complete building the team by year-end, which will enhance our capacity to make new sales and expand product offerings to our existing commercial client base as we enter 2015.

So to sum up the third quarter, we are executing on our plans. To take advantage of Medicaid expansion in both our commercial and state markets, to broaden and deepen our commercial market presence, and to reduce operating expenses. Importantly, we have made this progress while preserving our historically strong base of state customers, and reigniting growth over the last two quarters in our COB business.

Before turning the call over to Jeff, I want to tell you how we see the Medicare RAC reprocurement process. The associated litigation, and the CMS settlement offer to certain providers designed to reduce the appeals backlog.

The litigation, which has effectively blocked CMS from making the new contract awards, is now pending in the Federal Circuit Court of Appeals. The court has approved an expedited briefing schedule, with all briefs to be submitted by December 1st. And it appears from the public docket, that oral argument is expected early next year.

How quickly the court will rule after oral arguments are heard is only a guessing game at the moment. How they might rule and what impact the various range of possible rulings will have on the timing of contract awards is even more speculative. So we cannot provide any meaningful insight at this point as to the ultimate impact on HMS.

We continue to believe that the Medicare RAC program, which according to the September CMS report to Congress returned more than $3 billion net to the Medicare trust fund in 2013, is valuable and should be sustained. Since the recoveries for 2014 will be dramatically lower than prior years, we believe it is important to expand the existing program now. And to make the new awards as soon as possible after there is clarity from the courts.

There is little we can say with regard to the CMS offer to certain providers to settle pending appeals relating to in-patient hospital stay audits at 68% of the net allowable now. And its potential impact on our fees earned in connection with those audits. CMS may take the position that RAC should receive only a portion of the amount they are typically entitled to for any appeals that are settled, and repay the difference.

We have received no formal communication from CMS. So any comment at this time is premature, and we do not intend to engage in speculation about what CMS may do regarding RAC fees. However, I thought it was important to provide our current thinking on the Medicare RAC reprocurement process, because we are asked about it so frequently.

In my view, our year-to-date performance clearly demonstrates how much the successful execution of our overall growth strategy has reduced the significance of Medicare RAC revenues relative to the other components of our business. Jeff is up next and he will provide his views on the quarter.

I want to take this opportunity to say how pleased we are that he agreed to join the HMS executive team. Jeff's financial acumen, attention to detail, insistence on rigor throughout the finance organization. And important insights, based on 25 years in healthcare on the provider side of the business, are already quite evident.

Jeff?

Jeff Sherman *- HMS Holdings Corporation - CFO*

Thank you, Bill, and good morning, everyone. Before giving you my thoughts on our third-quarter results, I want to briefly provide some initial impressions of HMS.

I was at first attracted to the CFO opportunity at HMS based on the macroeconomic conditions facing both government and private healthcare payers in the US. With an aging population, expansion of Medicaid coverage under the Affordable Care Act, and increasing budgetary constraints, the opportunity for companies that can help our healthcare system operate more efficiently is significant. In addition, commercial payers are looking for ways to ensure that healthcare dollars are spent wisely.

As I explored the opportunity more, I recognized that HMS is uniquely positioned to utilize its technology, processes, professional staff, and institutional knowledge to help reduce inefficiencies and errors for both government and private payers. I was also attracted to the long-term growth potential of HMS and its financial performance over time. Including both organic growth, and growth through selective acquisitions.

The Company's very strong balance sheet and ability to generate free cash flow were also important considerations for me. Finally, I was impressed with Bill's vision for the future, and the management team he has assembled to help capitalize on the significant growth opportunities the Company has.

After two months on the job, I can tell you that I am excited about our future based on my early observations. I am initially focusing my time on learning the nuts and bolts of the business, and understanding the revenue and cost drivers that impact our results. This includes deep dives into our operations and participating in our annual strategic planning and budgeting process, which was already under way when I joined.

I'm also spending time looking at our capital structure, and how we can best deploy our significant free cash flow to help maximize long-term results. I look forward to working with Dennis and Bill, and reaching out to our stakeholders over the coming months.

Now, turning to the third-quarter results. I want to focus on a few key areas, operating expenses, operating margin, capital allocation, and 2015 guidance. Which we intend to provide on our fourth quarter call next February.

Operating expense leverage presents an important opportunity to expand margins and profitability. As we complete our 2015 planning process over the next few weeks, we are thoroughly examining all aspects of our business. In order to determine how we can operate more efficiently, how we can automate processes where appropriate, and how we can increase the yield from our existing product suite.

We projected operating margin expansion at the beginning of this year, excluding Medicare RAC, of 500 to 600 basis points on a 2013 revenue base of $384 million. Year-to-date non-Medicare RAC revenue of $312 million is 8% higher than the first nine months of last year.

We expect fourth-quarter revenues to be roughly in line with the third quarter. Which would put the full year non-Medicare RAC revenue solidly within the 10% to 11% growth range we projected at the beginning of the year. We are also on course to achieve the full year margin expansion we anticipated.

We felt of confident going into 2014 about our ability to project revenue and expenses in the non-Medicare RAC aspects of our business. On the other hand, we knew there would be considerable uncertainty regarding new RAC awards that would have significant revenue and expense implications.

We have taken steps throughout the year to minimize the financial impact of the RAC revenue decline. While preserving the expertise of employees who have contributed so much to our consistently high Medicare RAC performance ratings.

We reduced FTEs early in the year, and were able to successfully redeploy others. Since their Medicare RAC experience is directly relevant to products and services, we are now selling in greater numbers in the commercial market.

We have been asked frequently to size the costs of the current overhead we are carrying in connection with the Medicare RAC business. Isolating those costs this year has been challenging, because of the individuals we deployed and the nature of certain costs associated with the RAC contract.

We have fixed costs such as IT and occupancy, for example. Which are not tied exclusively to Medicare RAC, and would not go away even if we were doing no RAC business. Additionally, amortization tied to the HDI acquisition is a non-cash item that is unrelated to the level of employment associated with the RAC contract.

We have spent time recently assessing what our current cash overhead is, primarily compensation and benefits, on a go-forward basis related strictly to the Medicare RAC contract. As of the end of the third quarter, we had approximately 85 FTEs exclusively dedicated to Medicaid RAC. Our goal is to enter 2015 with RAC related direct cash costs projected to be as close to breakeven as possible.

We believe the current level of employees will allow us to do so. Assuming the present scope of work is not expanded, and quarterly RAC revenue is approximately $3 million, beginning next quarter, and continuing until new awards are made.

By keeping a core Medicare RAC staff in place, we will have the capacity to manage our obligations under the existing contract. And we'll be able to quickly ramp up for additional work once new Medicare RAC contracts are awarded. We also have the added flexibility, if necessary, to pull back individuals that were redeployed this year within HMS.

Medicare RAC ref revenue of $19.3 million was down 77% through the first nine months of the year, compared to $82.6 million through September 30th of last year. Despite this dramatic decline, our overall revenue through the end of the third quarter was down just 10%. As we focused attention on our core COB business, and growth opportunities in the commercial market, as Bill mentioned.

The significant decline this year in Medicare RAC revenue and the lengthy delay in the reprocurement process is as frustrating for us as it is for all HMS stakeholders, particularly our investors. It is important to remember, however, that we are on track to achieve the significant revenue and margin goals we established at the beginning of the year for our non-RAC business. Our focus on these growth markets is a key component of our 2015 planning, which we will describe in more detail on our fourth quarter call.

The Company's strong balance sheet and quarterly cash flow provide enviable flexibility over time to utilize capital for acquisitions, share buybacks, debt repayment and investing in future growth. I believe that our management and Board should consistently look at all traditional means of capital utilization, and all methods for returning value for our shareholders. And I consider leading that effort to be an important aspect of my CFO role.

In the third quarter, we accumulated $24 million of additional cash. Which raised cash and cash equivalents to $120 million at quarter end, up approximately 25% compared to June 30. We are content to continue to build in cash and capital through year-end in anticipation of the full range of potential uses in the coming year.

Before closing, I want to explain our thinking regarding 2015 guidance, which we intend to provide on our fourth quarter call next February. The biggest driver of that timing is the fact that our 2015 planning and forecasting process will not be completed until December. Two big revenue uncertainties, Medicare RAC and 2015 state contract procurements are additional factors.

Though neither revenue item is likely to be resolved by February, we hope to have significantly more visibility on both by then. As a result, I urge caution in projecting the various components of our 2015 performance until we have provided our guidance early into next year.

Bill will now have closing remarks before we take questions.

Bill Lucia - *HMS Holdings Corporation - President & CEO*

Thank you, Jeff.

As I reflect on 2014, which is rapidly drawing to a close, I want to thank the entire HMS team for their dedication and hard work. Which is reflected in the Company's strong financial performance through the first three quarters of the year. We have executed on our growth strategy in the face of the precipitous decline in Medicare RAC revenue, and the extended procurement process for the next RAC contracts.

Our historically strong working relationships with state governments also remain an important market opportunity for us. Despite the ongoing shift from fee for service to managed care.

Our markets are highly competitive. And, as I mentioned earlier, we face a particularly challenging 2015 in terms of state government procurements. As we enter the new year, I am confident of our proven track record of cost containment. And it positions us well for success.

The Medicaid expansion was a large growth driver for us this year, and that tailwind appears as if it will carry us into 2015 as well. Continuing to grow our commercial market presence and further rationalizing our cost structure will be additional areas of focus, as we wrap up 2014 and move into next year.

One important key to our success over the years has been listening carefully to our customers. The challenge for all payers, government or commercial, to contain costs while providing quality healthcare products and services has just never been greater. We remain firmly committed to working with our customers to refine existing products, and develop new ones to meet their needs.

Building on our experience and expertise, while innovating to meet customer needs, presents ongoing opportunities for HMS to grow. In short, I am very pleased with our year-to-date performance, and optimistic about our future.

We're now ready for the first question.

QUESTIONS AND ANSWERS

Operator

Thank you.

(Operator Instructions)

Our first question comes from Mohan Naidu from Stephens Incorporated. Your line is open.

Mohan Naidu - *Stephens Inc. - Analyst*

Thank you very much for taking my questions. Bill, maybe I'll start on the reprocurement.

You said 2015 is going to be a heavy reprocurement year. Would you care to quantify what percentage of your state revenues would be up for regrab in 2015?

Bill Lucia - *HMS Holdings Corporation - President & CEO*

Thank you, Mohan. So we're actually close to about 40% of 2014's revenue is up for reprocurement in 2015. Now that's staggered throughout the year, it represents 12 state clients. And of course the two largest clients in our portfolio are New York and New Jersey, and they're included in the numbers.

Jeff Sherman - *HMS Holdings Corporation - CFO*

Just to be clear, this is Jeff, that's 40% of the state revenue.

Mohan Naidu - *Stephens Inc. - Analyst*

Right.

Jeff Sherman - *HMS Holdings Corporation - CFO*

Total state revenue.

Mohan Naidu - *Stephens Inc. - Analyst*

Okay. Got it. And maybe quickly on the commercial front, you mentioned delay in implementations causing some trouble there. Should we continue to expect 25% to 30% growth for the full year, or should we look at a little lower?

Jeff Sherman - *HMS Holdings Corporation - CFO*

This is Jeff. We expect, based upon our results for the first three months of the year, that we're going to come in around the 16% to 18% growth for the year on the commercial business. And as we said in our prepared remarks, our state revenue was over our plan. So we still are confident in our ability to hit the 10% to 11% overall revenue growth that we projected early in the year for the non-Medicare RAC business.

Mohan Naidu - *Stephens Inc. - Analyst*

All right. Maybe one last question.

Bill, you talked about CMS offer to settling or $0.68 to $1. Do you see more clients taking on that offer? How are the clients reacting to that?

Bill Lucia - *HMS Holdings Corporation - President & CEO*

I think you mean the providers.

Mohan Naidu - *Stephens Inc. - Analyst*

Providers, sorry.

Bill Lucia - *HMS Holdings Corporation - President & CEO*

It was offered to certain providers, so there's certain types of providers that did not receive the offer. At this point, I believe the hospitals that will take advantage of this opportunity have to submit requests to CMS. CMS will respond to them.

But basically a list of eligible claims for settlement. It's not all claims, it's not all providers. And it's also just for word of caution, it's across all auditor types.

So it could include appeals from MICs, ZPICs, [Quicks]. I know I'm throwing you alphabet soup. And also the RACs. At this point, we don't have any insight into which hospitals have accepted the settlement and which will continue to go through the appeals process.

Mohan Naidu - *Stephens Inc. - Analyst*

Okay. Just to clarify, you said you don't know at this point if the clients accept those offers, providers accepted offers, how that will impact your revenue.

Bill Lucia - *HMS Holdings Corporation - President & CEO*

Well, it's unclear at this time. As I mentioned in the discussion in the call, there has been no formal communication from CMS regarding the impact on RAC fees. And at this point, there have been no -- there has been no data given to us about providers that have actually filed settlements and received settlement payments.

Jeff Sherman - *HMS Holdings Corporation - CFO*

So the original deadline was October 31st for providers, and we're not sure how that's going to play out.

Mohan Naidu - *Stephens Inc. - Analyst*

Okay. Great. Thanks for taking my questions.

Operator

Thank you. And our next question comes from Bret Jones from Oppenheimer. Your line is open.

Bret Jones - *Oppenheimer & Co. - Analyst*

Good morning, and thanks for taking the questions. I wanted to start with the COB growth. I know you talked about yield improvements, and I was wondering if you could give us any sense for the split in the growth between ACA and yield improvements and also upselling to customers?

Jeff Sherman - *HMS Holdings Corporation - CFO*

Approximately about a quarter of the revenue growth is coming from yield improvement. So that handles the yield improvement side of the equation.

Bill Lucia - *HMS Holdings Corporation - President & CEO*

And then we would anticipate -- it depends on market. And we don't have really the data at this level of refinement, because not all of our clients can accurately notify us which lives are coming from ACA expansion. But we would guess that about half of the growth is coming from expansion, and another 25% is actually new or same store sales.

Bret Jones - *Oppenheimer & Co. - Analyst*

Okay. Great. That's helpful. Thank you.

Also wanted to try and reconcile a little bit more on the PI, the decline in the PI business. You said there were commercial deals that were delayed. And I'm just wondering do you have a sense for implementation timing?

Are those delayed into next year? Do you think they're going to be -- or are they just on permanent hold for now?

Bill Lucia - *HMS Holdings Corporation - President & CEO*

I don't believe we have any of our new sales closed from Q4 through the balance of -- Q4 2013, through the balance of this year on permanent hold. We had a number of sales that took longer than anticipated. Let me give you a little color on the reasons.

The data that we need to do complex clinical review and interpret payment policies, it's very detailed. And at times, even our existing clients are not giving us all of that data. So we have a data refresh that has to be done.

Even though it does generate revenue and returns for our clients, sometimes it's a long queue of implementations or work for their IT shop. So that can take some time. And of course there is quite a bit of time in interpreting payment policies, and advising clients of actual either clinical policy changes or payment policy changes.

So that's part of the implementation. A number of the sales that we had done in Q4 of last year and Q1 of this year are now at the final stages of implementation, and audits have begun. So we'll see that continue to roll out through Q4 and Q1 of next year.

Bret Jones - *Oppenheimer & Co. - Analyst*

Okay. Great. One last quick question. Today on the PI piece as well, the sequential decline. Is there anything going on in the ZPIC or MIC contracts that would explain the sequential decline?

Bill Lucia - *HMS Holdings Corporation - President & CEO*

Not from the Mick contract perspective. On the ZPIC contract, there's probably been some decline year-over-year on the number of -- and most of the work we did there was auditing providers put on suspension.

So there haven't been as many providers put on suspension, so we have fewer audits in the ZPIC arena. But it's not really an appreciable impact on a quarter-over-quarter basis.

Jeff Sherman - *HMS Holdings Corporation - CFO*

And on a year-over-year basis, we were a subcontractor to a prime contractor where they lost the award in last year. So that's having some impact year-over-year as well.

Bret Jones - *Oppenheimer & Co. - Analyst*

Great. Thank you very much.

Operator

Thank you. And our next question comes from Brooks O'Neil from Dougherty & Company. Your line is open.

Brooks O'Neil - *Dougherty & Company - Analyst*

Good morning. I was hoping you could help me understand.

I don't always get a clear picture of the commercial business. I'm curious what percent of the commercial business you have today is with players that are involved with Medicaid, versus what I think of as traditional commercial health insurance providers?

Bill Lucia - *HMS Holdings Corporation - President & CEO*

Well, let me -- Brooks, let me try to answer that question. First, we don't always track to the specific level of detail the source of the commercial lives that we're processing. But about two-thirds of our business is Medicaid managed care.

Brooks O'Neil - *Dougherty & Company - Analyst*

Okay.

Bill Lucia - *HMS Holdings Corporation - President & CEO*

The balance of the business is a split between Medicare Advantage and true commercial. And the Medicare Advantage line of our business of course is growing, because of our success as a Medicare RAC auditor and the appeal of that cycle of audits to the Medicare Advantage plans.

Brooks O'Neil - *Dougherty & Company - Analyst*

Sure.

Bill Lucia - *HMS Holdings Corporation - President & CEO*

We're hoping in the future to have more granularity around those numbers, and be able to talk about how that impacts our growth going forward.

Brooks O'Neil - *Dougherty & Company - Analyst*

You see good opportunity for you to utilize your capabilities with, again, what I consider true commercial health insurers in today's marketplace, don't you?

Bill Lucia - *HMS Holdings Corporation - President & CEO*

We do. The appeal to a commercial insurer, for the most part, is their at-risk population. So that would be their growing population coming from the marketplace exchanges, their small group or individual or larger group at-risk population.

There's a little less applicability on the coordination of benefits side, only because benefit plans have been changed over time. There's been spousal exemptions, there's been a lot other things that have happened where true commercial on commercial COB is not as large of an opportunity. But all of our other services play well in the commercial risk space.

Jeff Sherman - *HMS Holdings Corporation - CFO*

This is Jeff. I think it's important to note that some of the capabilities that we've acquired through the HDI acquisition are applicable on the commercial side of the business. And we have redeployed staff to help with the growth that we've seen in the commercial side, and the growth we're expecting over time.

Brooks O'Neil - *Dougherty & Company - Analyst*

Sure. That all makes sense. I just have to ask one other question.

I'm curious. You made a pretty compelling case for the decreased significance of RAC in your business, and obviously the continued significant uncertainty with regard to the prospects therein. I'm curious if you have any discussions with your auditors related to impairment of your goodwill or intangibles related to the HDI acquisition?

Jeff Sherman - *HMS Holdings Corporation - CFO*

Well, I think a couple important points. We have one reporting unit as a Company, and so we do goodwill impairment testing as required on an annual basis. And any time anything significant changes and we have -- we don't expect any potential impairment at this point in time, and the facts would not support any change in our goodwill that's recorded at this time.

Brooks O'Neil - *Dougherty & Company - Analyst*

Okay. Thanks a lot, Jeff.

Operator

Thank you. And our next question comes from Ryan Daniels from William Blair. Your line is open.

Ryan Daniels - *William Blair & Company - Analyst*

Thanks for taking the question, guys. Jeff, maybe one follow-up to start with for you.

Can you talk a little bit about the margin impact of the growth rates changing from your initial expectations between commercial and the government business? So all else equal, would that be accretive to your original margin thoughts?

Jeff Sherman - *HMS Holdings Corporation - CFO*

Commercial overall typically has had some higher margins. But with the significant state growth that we've seen, we still expect it to hit the margin expansion in total that we projected early in the year.

Ryan Daniels - *William Blair & Company - Analyst*

Okay. And maybe this is a number you don't have, but if we look about the last three or four quarters in regards to the number of new lives you've added on the commercial front. Do you have an implementation queue number you can give to us, i.e., how many you've sold and then how many have already been implemented?

Jeff Sherman - *HMS Holdings Corporation - CFO*

As Bill said, the timing of the implementation changes over time. But in terms of the numbers sold, we had 6.1 million lives in Q1. We had zero new lives in Q2, and we had 1.8 million lives, as Bill noted in his comments, on Q3.

So that gets you to the 7.9 million lives. We expect this to be lumpy just based upon the sales process. And again, the implementation timing are different for each contract.

So it's hard to predict from a rollout perspective when exactly they're going to hit. Because each contract is unique and has unique circumstances.

Ryan Daniels - *William Blair & Company - Analyst*

Sure. But do you actually know of those 7.9 million that you've sold, how many are actually generating revenue at this point and how many are future revenue generators?

Bill Lucia - *HMS Holdings Corporation - President & CEO*

Yes, Ryan. We have a -- we have a ballpark around that. The challenge really is -- and I think I've discussed this before. When you get into going live on a specific product, and some of the -- Jeff had mentioned new lives, and then we added product to about 10 million existing lives over this year-to-date.

When you get into an actual product implementation, we may get -- and I'll give you an example. We may get a small regional component initially. So as the client's gone through the pilot, they're testing their impact on providers, we're very focused on doing provider impact analyses to make sure that when they extrapolate it across their entire provider base there's not a lot of abrasion.

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So it's really hard to say how many lives are actually implemented, and generating revenue versus those in the implementation queue. And a good example is if we have 1 million member Medicare plan that's going live, they may start with 100,000 members in a given region. And go through the process with us, testing that, and then turn on other regions.

Same with the Medicaid state -- Medicaid managed care plan. They may implement state by state. So it's really hard to give you actual numbers on the lives that are generating revenue, because the implementations are always in flux.

Ryan Daniels - *William Blair & Company - Analyst*

Okay. Very helpful color. Maybe last one, again, just a follow-up.

It seems like the sales are a little bit lumpy, obviously Q2 is very heavy for add-on sales. It seems like Q1 was the heaviest for new clients. Is there really any cadence we should be looking for going forward in the commercial i.e., things might be heavier at the start of the year or mid-year to allow for lives that go through open enrollment?

Anything of that nature? Is it just a matter of timing and lumpiness that we're going to see going forward?

Bill Lucia - *HMS Holdings Corporation - President & CEO*

I really think it's a typical sales cycle. Some accounts could close in a matter of months, some could take much longer to close. I don't think there's a trend that you can read into the lumpiness.

We have customers that are looking for cost savings now, but not everything can be -- a switch can't be flipped and have generating revenue for them within a month. So the sales queue of course, we have a very active sales queue.

And I think you'll continue to see the lumpiness on the new sales closed, as well as expansion products. There's really nothing that we can tell you that there's a seasonal impact here.

Ryan Daniels - *William Blair & Company - Analyst*

Okay. Perfect. Thanks for all the color, guys.

Jeff Sherman - *HMS Holdings Corporation - CFO*

Thank you.

Operator

Thank you. And our next question comes from Charlie Strauzer from CJS Securities. Your line is open.

Charlie Strauzer - *CJS Securities - Analyst*

Thanks for the color. By the way, on the delays that you'd talked about some of the implementations. Can you perhaps maybe quantify it a little bit more in terms of the revenue impact on the quarter?

Bill Lucia - *HMS Holdings Corporation - President & CEO*

Charlie, I think it's part of the reason that our PI revenues were down, and the commercial revenue growth was not as high as expected. I don't know if we can actually give you the actual numbers of expected versus what's actually was generated in the quarter.

But through the number of lives that we've sold, there are probably in excess of 1 million lives in implementation that have not been generating revenue that we thought would be by Q3. Again, many of the sales are going live this quarter, meaning that we're just starting to mail audits. And as I mentioned before, when we start to mail audits it may be on a smaller population until we ramp up with our client.

Charlie Strauzer - *CJS Securities - Analyst*

Got it. And then looking into next year, besides the reprocurement that's coming up, what are some of the potential limiting factors that could curb some of the good growth that you've been seeing in the back half of the year?

Jeff Sherman - *HMS Holdings Corporation - CFO*

We're going to defer any 2015 questions until we give our guidance next February at this point.

Charlie Strauzer - *CJS Securities - Analyst*

Great. And then Jeff, just one last thing. Given your new arrival, any change to the thoughts on cash deployments in terms of priorities?

Jeff Sherman - *HMS Holdings Corporation - CFO*

No, I think as I mentioned in my prepared comments, I'm certainly looking at our capital structure. The first priority continues to be expanding our product portfolio, and through both internal product development and through acquisitions.

As I noted, that strong balance sheet and strong cash flow gives me a lot of comfort. And I think gives the Company a lot of flexibility on pursuing the growth opportunities we have.

So it's something I'm continuing to evaluate, and will certainly discuss with Bill. And we'll have an active dialogue with the Board of Directors as well about the opportunities for us to deploy that cash flow to drive shareholder value.

Charlie Strauzer - *CJS Securities - Analyst*

Thank you very much. That was very helpful.

Jeff Sherman - *HMS Holdings Corporation - CFO*

Thanks.

Operator

Thank you. Our next question comes from Richard Close from Avondale Partners. Your line is open.

Richard Close - *Avondale Partners - Analyst*

Great. Thank you. Jeff, welcome. Dennis, welcome. Congratulations on a good quarter.

I was wondering if you could just go over the RAC commentary. I just want to make sure I have that right. In terms of what you're targeting on a go-forward basis in terms of the revenue.

And then I think you mentioned breakeven, and I just want to make sure I understand that. Because we were thinking you were carrying about call it $14 million, $15 million in quarterly cost in that part of the business.

Jeff Sherman - *HMS Holdings Corporation - CFO*

Yes. So a couple comments on that. First, I think we've been disciplined regarding our cost reductions as the volume of the RAC revenues declined. And as I noted, we are deploying some of those staff to the growing number of commercial recovery audit business that we have.

We did recently take a look at our RAC operating cash costs. And at this point, as I said in my prepared remarks, those costs are primarily compensation and benefits. And we have 85 FTEs strictly working on the RAC contract right now.

And that's averaging about $3 million a quarter in costs. And that's what we're expecting our go-forward revenue to be.

So Q3 was the low point in terms of RAC revenue, we believe, at $1.4 million. We're expecting that to ramp up a little bit in Q4, and stay at that level. Remember, during Q3, there was actually a period where there was no work being done, so we did think that was the low period.

We expect that to improve a little bit in Q4. And that to be the go-forward run rate, unless the scope is expanded for us in the Medicare RAC business.

So as we enter the next year, we're expecting that 85 FTEs and the costs associated with that of about $3 million a month -- a quarter, to be the go-forward cost. So when I say breakeven, I'm saying basically on an EBITDA, cash operating cost basis, that's excluding any amortization from HDI going forward.

Richard Close - *Avondale Partners - Analyst*

And then can you give us a ballpark of what the quarterly amortization associated with the intangibles of HDI are?

Jeff Sherman - *HMS Holdings Corporation - CFO*

It's about $6 million a quarter.

Richard Close - *Avondale Partners - Analyst*

Okay. Great. And then with respect to the rebids, obviously a big year next year.

Bill, I was curious how you think the competitive marketplace is currently? You mentioned pricing pressure and allow you to elaborate a little bit on that. Just your overall confidence in where HMS sits in the pecking order, I guess, with respect to these rebids, and just the competitive marketplace.

Bill Lucia - *HMS Holdings Corporation - President & CEO*

Thanks, Richard. Well look, any time large contracts are up for rebid, competitors are definitely circling the wagons and looking for ways to gain additional sales. But I can tell you that our competitive advantages have always included the sitting, existing, very large eligibility data warehouse that we've developed over time. And that's used on behalf of Medicaid and other government programs.

The sophisticated algorithms and matching logic that we've used that has still not proven to be surpassed by anyone in the market. And then just this technology infrastructure that we've built over time.

It allows us to continue to provide the highest return on investment in the marketplace. All that said, we take competitors seriously, and we know that it may bring some pricing pressure in our rebids.

Richard Close - *Avondale Partners - Analyst*

Do you see states potentially bringing stuff in-house, or any one competitor out there that is I guess surfacing?

Bill Lucia - *HMS Holdings Corporation - President & CEO*

On the former, there's always a shift back and forth. Though we really haven't seen any state wholesale bringing services in-house.

And as you know, when you've seen one COB contract, you've seen one COB contract. So in one state we may be doing a good portion of the work as a primary vendor. In other states, we may be a secondary or tertiary vendor behind state employees and potentially their MMIS vendor.

So it's a very varied distribution of our product. In terms of competitors and emerging competitors, of course we don't really like to give our competitors air space on our call. But in reality, we've always taken competition seriously, and in this case we're preparing for that competition as we go into a pretty heavy reprocurement year.

Richard Close - *Avondale Partners - Analyst*

Okay. Thank you.

Operator

Thank you. And our next question comes from Robert Willoughby from Bank of America. Your line is open.

Robert Willoughby - *BofA Merrill Lynch - Analyst*

Hello, good morning, this is actually Elizabeth Blake in for Robert today. If we could just follow up on the program integrity implementation delays.

I guess could you just elaborate a little bit on why that was such a large issue in the quarter, and maybe what gives you confidence that will be resolved near term? Should we be modeling more of an impact toward the first half of next year, or do you expect it to be resolved by then? Thanks.

Jeff Sherman - *HMS Holdings Corporation - CFO*

This is Jeff. I'll start, just on the numbers side, and let Bill jump in. I think for the quarter, we had 18% growth which was pretty close to the low end of the range we gave. And that has been improving.

So I think when we say overall for the year, we expect to come in on the lower end, it's because we are gaining traction as we move throughout the year. So I think for the quarter, we had good growth at 18%, which is very close to the low end of that range we gave. Some of the delays that we talked about is the reason why we're not having more traction for the full year number.

Robert Willoughby - *BofA Merrill Lynch - Analyst*

Okay. That's helpful.

And then Jeff, could you just describe your philosophy around the guidance, what should we expect here? Would you choose not to be speculative on the RAC, or should we expect a full EPS statement in February? Whatever you have would be helpful.

Jeff Sherman - *HMS Holdings Corporation - CFO*

I'm not going to speculate on the guidance. When we give guidance in February, Elizabeth, we'll go through the process.

We'll give you our assumptions behind it, and give you a range of outcomes that we expect. Other than that, I wouldn't say any more about that at this point.

Robert Willoughby - *BofA Merrill Lynch - Analyst*

Okay. Thanks very much.

Jeff Sherman - *HMS Holdings Corporation - CFO*

Thank you.

Operator

Thank you. And our next question comes from Dave Windley from Jefferies. Your line is open.

Dave Windley - *Jefferies & Co. - Analyst*

Hello. Can you hear me okay?

Jeff Sherman - *HMS Holdings Corporation - CFO*

Yes.

Dave Windley - *Jefferies & Co. - Analyst*

Great. Thanks for taking the questions. So I wanted to focus on margin. You mentioned that you're on track to hit the goal, which I think was 500 to 600 basis points of margin leverage in the non-RAC business.

Bill, what I'm interested in or maybe both of you, what I'm interested in is I suppose how hard you've had to push the envelope to get to that? And does that mean you've continued to invest in the platform, invest in new product development, things that are needed on a steady basis? Or has this year been a relative underinvestment year in order to get to those margin goals that you set for this year?

Bill Lucia - *HMS Holdings Corporation - President & CEO*

Dave, this is Bill. Let me start with that. So let me give you a little color around some of the investments we're doing.

One, of course, is ongoing technology platform integration. That is an investment. It's an investment of course that has high ROI, because it reduces the applications that we end up having to maintain over the longer term. So that is an investment we're making this year, and we'll continue to make next year.

The other is -- and I think we mentioned this in our last conference call. But this year, we carved out a special product engineering function.

We invested in that function, and it's basically to have product managers who will manage all of our existing products. Continue to focus on the competitiveness of the product in the market, as well as develop and engineer new products. Working closely with market research and other areas of the Company.

So we do continue to make investments while we have been sharpening the pencil on our operating costs. I think a key component is, we have really applied much more operational science to our business than we have in the past. As I mentioned, we've hired a number of Lean Six Sigma black belts that have been going through the organization, cutting out costs and actually improving the product yield which is another very positive outcome from that process.

So I wouldn't say that we're underinvesting in the platform. I'd say we're investing wisely. And then the last comment of course is, to bring competitive product to market we may be acquiring to do that versus just building, as the time to market is important to us as well.

Jeff Sherman - *HMS Holdings Corporation - CFO*

And this is Jeff. Just from a financial perspective, even if you look at our capital investments. Through the first nine months of last year, we spent about $21 million in capital investments, including investment in capitalized software. We're at about $19 million this year.

So some of that is just timing of investments. But I can tell you since I've been here, the Company is focused on pursuing growth and investing in growth. And it's committed and has made those investments at the same time as we're looking to become more efficient. We haven't sacrificed one for the other.

Dave Windley - *Jefferies & Co. - Analyst*

That's very helpful. If I could just follow on that.

Conceptually, I want to, Jeff, stay away from 2015. But if -- it does seem like a business that has some attractive leverage characteristics to it. And so just conceptually, can you talk to us about how we should think about top line growth driving further leverage in the business?

Jeff Sherman - *HMS Holdings Corporation - CFO*

I won't necessarily talk about top line growth. I will say I think with our investments in our platform that that growth -- we can get leverage off of growth.

And I think as you look at 2014 and see the significant decline that occurred in the RAC revenue and the way the Company responded, we overcame a fair amount of those challenges in 2014. Just through the non-RAC revenue growth and the operating efficiencies we achieved.

So I think there is leverage that we can achieve in the business when we make these investments. And I think -- as I think about our prospects over time, that certainly is an important aspect as you think about the Company's future.

Dave Windley - *Jefferies & Co. - Analyst*

Very good. Thank you very much.

Operator

Thank you. And our last question comes from Frank Sparacino from First Analysis. Your line is open.

Frank Sparacino - *First Analysis - Analyst*

Hello, guys. Just one quick one from me. On the rebids for next year, is it fair to say if you look at New Jersey and New York, that's more than half of the 40% at risk?

Jeff Sherman - *HMS Holdings Corporation - CFO*

I think that's right. Correct.

Frank Sparacino - *First Analysis - Analyst*

Okay. And then maybe just one follow-up there. So on the -- Bill, I think you had commented about the commercial sales force buildout. And wondering if you could just quantify that, whether it's dollars, people, et cetera?

Bill Lucia - *HMS Holdings Corporation - President & CEO*

Thanks, Frank. So we did have a small commercial sales force in place already. We've been adding to that sales force, as I mentioned last quarter. We hired someone to lead that sales force under Doug Williams, Brent Sanders, who led all payer sales for all scripts.

So it comes with a great pedigree, and ability to quickly bring us into new accounts and help us expand accounts. And then we added two other additional net new sales executives within the quarter, who are learning the HMS products and are hitting the ground running. So we are pretty close to building out the sales force.

I'm not really sure about the actual dollars, but we're also distributing the sales team across different types of opportunities. So large national accounts that continue to grow, actually pretty rapidly, the regional players that may need to outsource more of these services than a larger player, and then of course a deeper dive into the blues. So we are looking at specialized salespeople across different markets.

Frank Sparacino - *First Analysis - Analyst*

Great. Thank you guys.

Operator

Thank you. And I'd now like to turn the call back over to management for any closing remarks.

Dennis Oakes - *HMS Holdings Corporation - SVP of IR*

That concludes our call today. Thank you very much for listening, and just to a reminder that there will be a replay of the call up later this morning on our website. Thank you.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone have a wonderful day.
