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HMSY - Q4 2014 HMS Holdings Corp Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the HMS fourth-quarter 2014 earnings conference call. (Operator Instructions) As a reminder, this conference call is being recorded.

I would now like to turn the conference over to Dennis Oakes. You may begin.

Dennis Oakes - *HMS Holdings Corp. - SVP IR*

Thank you, Nicole. Good morning and thank you, everyone, for joining the HMS fourth-quarter and full-year 2014 earnings conference call. With me today are Bill Lucia, our President and Chief Executive Officer, and Jeff Sherman, our Chief Financial Officer.

Our earnings release issued earlier this morning is available on the Company website at HMS.com under the Investor Relations tab. This call is being webcast and can be accessed via the Events and Presentations tab on our website, and a replay will be posted later this morning.

During the call we will be referring to certain non-GAAP measures. A reconciliation of those measures to GAAP is included in the press release. We have also posted our usual quarterly investor slides containing supplemental information, though we will not make specific reference to them on the call.

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. Such statements are based on the Company's current expectations, and actual events may differ materially from those expectations. We also 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, February 27, 2015, and the Company disclaims any intent or obligation to update any forward-looking statements as a result of developments occurring after this call.

We are ready now to begin with the prepared portion of the call, and then we will take questions. Bill?

Bill Lucia - *HMS Holdings Corp. - President, CEO*

Thank you, Dennis, and good morning, everyone. 2014 was a very solid growth year for HMS and a strong affirmation of our strategy over the last few years to concentrate on commercial expansion opportunities.

Full-year revenue of $421 million, excluding Medicare RAC, was 10% higher than the previous year, fueled by a 15% increase in commercial revenue. State government revenue was up 9% due primarily to the ACA-driven surge in Medicaid enrollments. Revenue generated by our coordination of benefits product suite, which accounted for more than 70% of total revenue, was up 14% year-over-year.

The past year did come with challenges. The prolonged reprocurement process for the new Medicare RAC regions dragged on throughout 2014 and will likely persist through much of the coming year. Phasing down, complete stop, and then limited restart of the current contracts reduced our full-year RAC revenue by 80% or $86 million, creating a revenue hole equivalent to approximately 17.5% of prior-year revenue.

We took the necessary steps throughout 2014 to reduce our RAC-related cash expenses while retaining the staff necessary to fulfill our current obligations and the key personnel needed when the new contracts begin. We were also able to redeploy a number of individuals previously working on the RAC contracts to support our growing commercial payment integrity business. We do look forward to participating in the new Medicare RAC program, but our focus for 2015 is elsewhere until such time as the new contracts are awarded and finalized.

I do want to take a few minutes now to examine the growth we experienced in 2014, which will lead to a discussion of our view of the year ahead. One caution before I begin: we have seen and expect to continue to see variations from quarter to quarter in many of our growth measures, including revenue and customer membership.

Many of the full-year trends we saw last year, however, are very encouraging. We saw strong growth in both our commercial and state revenues during 2014, though do not anticipate similar state growth in the year ahead.

On the other hand, commercial growth was ramping up throughout last year, and we expect that momentum will be sustained during 2015. On a year-over-year basis, commercial revenue grew 8% in the first quarter of last year, 14% in the second, and then 18% in both the third and fourth quarters as implementations of previously sold business took hold throughout the year.

Our largest commercial revenue source is Medicaid managed care, which also benefited during 2014 from Medicaid expansion. Medicare Advantage and at-risk group and individual plans are additional sources of commercial revenue.

We experienced robust commercial membership growth last year, adding 7.9 million new commercial members, which pushed total commercial lives in our customer base past 80 million. We also sold additional products, including clinical audits, credit balance reviews, and fraud, waste, and abuse services to existing customers covering 17.7 million lives during 2014.

Despite this progress, we continue to be underpenetrated with commercial customers relative to the number of products we sell to typical state customers, where we have been a player for nearly 30 years. We see no reason why our commercial customer penetration over time cannot approach the same level of approximately five products per plan member that we have achieved with state customers.

It is important to remember that our success in growing commercial revenues during 2014 was due to a heightened focus on market and customer opportunities, but it was accomplished without the benefit of deploying the enhanced sales force we built throughout the second half of last year. We anticipate these experienced and well-connected individuals will significantly boost new sales and sell expanded product offerings to our existing commercial client base during 2015.

In light of typical implementation periods of three to nine months, most 2015 revenue will be generated by business sold in the latter part of 2014 and the first few months of this year. Most new business sold in the second half will not have a revenue impact until 2016.

The biggest contributor to COB product growth last year was the influx of 8.8 million new Medicaid enrollees who entered our customer eligibility files throughout 2014. In general, we believe more covered Medicaid lives translates to more cost-avoidance transactions, more claims to review, and more spending under our existing COB contracts. So Medicaid expansion continues to be a growth driver for our business.

There are currently 28 states that have taken advantage of Medicaid expansion. The most recent is Indiana, which last month announced federal approval of its plans. Additional states expanding this year under plans acceptable to Republican governors could further fuel our Medicaid-based business, with either state fee-for-service members or managed Medicaid customers, since an estimated three-quarters of Medicaid enrollees are now managed by commercial plans.

As I said at the outset, 2014 was a solid year of revenue growth by a number of measures. I want to turn now to the year ahead.

Our Board and senior management team collectively have a clear vision of HMS as a growth Company. We have a well-thought-out strategy to achieve our targets, and we are operating with the benefit of several helpful tailwinds that complement that strategy.

We also face an element of uncertainty during 2015 with specific regard to state contract rebids and the new Medicare RAC awards, which makes broad-based guidance for this year a challenge. I will explain our financial projections for items on which we feel we do have good visibility. Jeff and I will also provide as much helpful information as we can about those areas we feel at present are difficult to predict for the year ahead.

A key element of our overall corporate strategy in recent years has been diversifying away from our historically strong reliance on government-based revenue. While we remain firmly committed to our state government customers and are hopeful we will play a role in the new Medicare RAC program, our greatest growth opportunity is with commercial health plans. We are following the lives that were formerly in state and federal fee-for-service programs but are now being managed by commercial carriers.

We expect top-line revenue growth for 2015, excluding Medicare RAC, of between 7% and 9%, with that growth coming principally from new or existing commercial customers. At the midpoint, that translates into expected commercial growth of about 20%.

We see the commercial expansion coming this year from organic growth within our existing accounts, including ACA-driven Medicaid growth; implementation of business sold in the second half of 2014; product yield improvement; and of course, new sales.

Ordinarily, we would expect annual organic growth in our state business to be in the low single digits. 2014 growth in the high single digits appears to have been driven largely by Medicaid expansion, which is not projected to occur at nearly the same level in 2015 as it was last year. As a result, our non-RAC revenue projection assumes 2015 state revenue will be roughly flat with 2014, even considering some incremental benefits from expansion that should flow through this year.

As we have indicated on several occasions, 40% of our 2014 state revenue or about $90 million is up for rebid this year across 12 states. How those RFPs are written will greatly influence the outcome of the competitive bidding process. As we wait for their release, a further assumption behind our 2015 revenue projection is that the scope of work and general pricing structure in newly contracted state business will be roughly equal to current arrangements.

As we disclosed at a conference in January, New York State exercised their option to extend for one additional year, to the end of 2015; and Tennessee extended for one year as well, to January 31 of 2016. Those extensions lessen the 2015 revenue impact of the rebid process. We still expect both RFPs to be issued later this year and awards to be made for January 2016 effective dates.

New Jersey extended our contract last October for six months, through April 30 of this year. We've not yet seen an RFP, and time is getting short for the state to complete the bid process and issue new awards by the end of April.

States typically will extend existing contracts as needed while procurements are pending. It's unclear at this point whether an additional extension will be issued by New Jersey and, if so, for how long.

As always, rebid opportunities that expand existing services would provide potential upside to our expected 2015 state revenue, while reductions in scope or changed pricing could have a negative impact.

We are highly confident in our ability to compete successfully for state contracts. That confidence stems from our simple value proposition: we offer a comprehensive suite of third-party liability services, with a long track record of success for the states we serve and a very compelling ROI on the billions of dollars we have recovered for our customers and the billions more in claims we have helped them avoid paying.

Jeff will provide some additional detail about our financial expectations for the year ahead, so I want to turn now to our thoughts beyond 2015 and review the macro and HMS-specific factors we believe will propel the Company through the next few years.

As I mentioned, our intermediate and longer-term growth expectations are based on both a number of favorable macro factors and HMS-specific actions. First, a variety of tailwinds will boost our business at least through the end of this decade. Those include the demographics of Medicare, which is projected to expand by about 16 million new members or 30% by 2023. Enrollment in Medicaid, driven primarily by the Affordable Care Act, will continue for the foreseeable future. CMS estimates 5% enrollment growth in 2015, and about 13 million new enrollees or 20% incremental growth by 2023.

More broadly, the health insurance exchanges, mandatory medical loss ratios, new health plan taxes associated with the ACA, and an increasing focus on pay-for-performance and outcome-based reimbursement policies all add more complexity and cost pressures for commercial health plans, which creates business opportunities for HMS.

And finally, strong evidence suggests that payment errors are growing in frequency, on top of the fact that overall medical expenditures increase yearly. The most recent Comprehensive Error Rate Testing or CERT program report from CMS, for example, showed the Medicare fee-for-service improper payment rate for fiscal-year 2014 increased to 12.7% or close to $46 billion, compared to 10.1% in the previous fiscal year.

We are also just beginning to tap the full range of opportunities with commercial customers. As a result, we believe that 20% annual commercial revenue growth over each of the next few years is achievable.

We expect this growth will come as a result of the several factors I just mentioned and will be reinforced by two specific internal strengths. First are the additional salespeople we assembled last year, now being deployed on a targeted basis to attract new clients and sell additional products to existing commercial customers. We now have the ability to reach health plan executives at a much higher level than previously and have identified four key areas of focus, including the big national plans, large regional plans, the independent Blues, and delegated risk organizations.

In addition to sales, this experienced group will work with the operations teams to ensure smooth and prompt implementations so we can shorten the cycle between contract signing and revenue production -- what we refer to as ink-to-green. As you know, elongated implementation of sold business negatively impacted our commercial revenue growth in 2014, though sales were well in line with projections; so fine-tuning the necessary process improvement is a high priority for us this year.

The other key factor which gives us confidence about the multiyear commercial growth opportunity ahead of us is the number of our existing customers that are now viewing us as partners in their business planning cycle. That is, they are coming to us, looking for ways to expand this relationship with HMS, because our prior work has resulted in tens of millions or hundreds of millions of dollars in savings falling directly to their bottom line.

I do want to touch on one final item before turning the call over to Jeff, and this is relating to litigation which resulted in a significant fourth-quarter expense and we expect will have further financial impact in the year ahead. Last August we filed lawsuits in Texas and New York against Public Consulting Group and five of their senior staff.

The suits allege that PCG and certain of their employees unlawfully misappropriated confidential, proprietary, and trade secret information belonging to HMS. They violated certain contractual relationships with HMS and committed other wrongdoing.

The lawsuits seek damages and injunctive relief. We believe this litigation is important to protect the Company's business and legal interests, and last year we incurred approximately $7 million in outside legal fees in connection with certain accelerated initial phases of the litigations.

The lawsuits are ongoing, and no trial dates have been set in either New York or Texas. As a matter of policy, we do not comment on pending litigation, so we don't plan on providing further detail or commentary except in any required public disclosures.

Jeff will now provide more of a deep dive into the fourth-quarter numbers and our expectations for 2015. Jeff?

Jeff Sherman - *HMS Holdings Corp. - EVP, CFO, Treasurer*

Thank you, Bill, and thank you to those listening for joining our call this morning. I want to start with the bottom-line numbers for the fourth quarter.

Three unusual items and an unexpected full-year tax rate of 47% reduced adjusted EPS by $0.11 in the fourth quarter to just $0.03 per share. We expect the effective tax rate to revert back to a normalized 42% in 2015; and the other items have no negative implications for the fundamentals of our business.

In fact, the core numbers for the quarter are fully supportive of the growth thesis that Bill explained in some detail. Specifically, the 47% full-year tax rate reduced fourth-quarter adjusted EPS by $3.4 million or $0.04 per share.

Though the complexities of multistate tax filers such as HMS generally defy simple explanations, the basic reason for our abnormally high effective tax rate of 47% in 2014 was changes in state apportionments and lower-than-expected net income. For instance, the state of Texas imposes a gross margin tax; 2014 total projected estimate of the Texas state tax was consistent from the third to the fourth quarter, but with net income declining the impact was to increase our effective tax rate for the year.

We also had states that changed the methodology on how state income tax was determined during 2014. As we went through the final year-end allocation methodologies, this also increased our tax dollars and impacted the effective rate. Finally, lower-than-expected net income in Nevada also impacted the full-year tax rate.

Three unusual items reduced fourth-quarter income by $12.1 million and impacted adjusted earnings by an additional $0.07 per share. These items include: $5.5 million in litigation expense related to the PCG lawsuits; $5.5 million in accounts receivable write-downs; and $1.1 million in severance costs.

As Bill explained, we do anticipate additional PCG-related litigation expense in the year ahead, but neither of the other fourth-quarter items are expected to have any meaningful impact on 2015 financial results. The write-downs were primarily due to two contract disputes that were resolved in the quarter.

I want to provide a bit more color on some of our fourth-quarter and full-year 2014 financial performance and then provide additional insight into our expectations for the year ahead. On the expense side, our process improvement initiatives continued to show benefit throughout last year. The total cost of services for 2014 was down $12.7 million or 4%, excluding a $3.1 million decline in acquisition-related amortization. Savings last year would have been in excess of $20 million but for the full-year severance expense of approximately $4 million and the $5 million bad debt expense in the fourth quarter.

Our focus on efficiency and lower operating expenses is ongoing. We believe there are further opportunities to reduce costs across the enterprise which will help lower the incremental costs and planned growth this year.

Our target during 2015 will be process improvements within our payment integrity product line, with the goal of improving product yield and generating a portion of expected increased program integrity revenue from that effort. Our COB products underwent a similar top-to-bottom process improvement review last year, and we continue to assess COB for further saving opportunities in 2015.

Overall, such cost-savings initiatives should continue to offset a portion of the incremental costs of growth and positively impact our bottom line.

As we mentioned on our third-quarter call, in anticipation of a full resumption of the Medicare RAC program under the new contract awards, and assuming we would likely win at least one of the four new regions, we have maintained sufficient staff to work on various aspects of the current limited-scope RAC contract. Our quarterly cash costs of $3 million for this staffing level, which we saw in the fourth quarter, is approximately equal to the anticipated quarterly revenue, assuming no change in scope or work under the current contract.

As to the timing of the new RAC awards, we remain hopeful that during this calendar year CMS will make final awards; that any protest -- and protests are likely -- will be resolved; and that required negotiations regarding the scope of work can all be completed by the end of the third quarter, so there are at least three months before year-end for necessary ramp-up. If all of that happens, then revenue on the new contract could begin to flow early in 2016.

With regard to the COB business, a large influx of new Medicaid enrollees during 2014 had a positive impact on both our commercial and state revenues. For the full year, COB revenue was $39 million or 14% higher than 2013.

Despite the fact that most new Medicaid enrollees migrate to managed care, our state fee-for-service business got a boost last year as reflected in the 8.9% year-over-year increase in state government revenue. Though it is difficult to analyze how much of incremental state revenue in 2014 was attributable to Medicaid expansion, we suspect that much of the $16.8 million year-over-year increase in state TPL revenue relates to cost-avoidance work arising from fees associated with the very large influx of new Medicaid members.

We typically do cost-avoidance work reasonably quickly after individuals are added to state Medicaid eligibility, so there will likely be some spillover benefit in early 2015 for those who enrolled at the end of last year, and a similar benefit for any new enrollments in 2015. We do not, however, expect the total revenue impact from new Medicaid lives to be nearly as significant this year as it was in 2014, because projected enrollment increases for 2015 are much more modest than last year.

Beyond the benefits of Medicaid expansion, sales activity in the fourth quarter included successful re-procurements in North Carolina, Alabama, Maryland, and the District of Columbia.

Looking more broadly at the year ahead, our annual revenue projection is built from the bottom up, assessing growth expectations as part of our planning, budgeting, and forecasting process. It is a challenge to anticipate where growth will come from on a product-specific basis. We are much more heavily penetrated with our COB products, however; so payment integrity is where the greatest opportunity lies and where we expect a meaningful percentage of our commercial growth will come from in 2015. The top four PI products we expect will generate the greatest interest from among existing and potential clients are fraud, waste, and abuse; prepay utilization review; coding reviews to detect overpayments; and automated and complex clinical reviews.

We generated cash flow from operations of roughly $100 million in 2014, got approximately $133 million in cash on hand at December 31, and year-end debt outstanding of just under $200 million. So our balance sheet provides a great deal of flexibility.

With regard to capital deployment, we did not make an acquisition during 2014, and we will remain disciplined in the coming year as we review potential opportunities. We certainly are finding many where seller expectations of value are beyond what we feel is reasonable; but we are also seeing a number of businesses and platforms we believe can be purchased at fair prices.

Our focus is on acquisitions that will complement our existing business or provide new capabilities, particularly with regard to fraud, waste, and abuse or data analytics, ultimately strengthening our value proposition and enhancing our earnings profile. Acquisitions remain our top priority for deploying available capital, and the likely higher capital needs under the new RAC contracts is not keeping us from moving forward.

We enter 2015 with a very solid balance sheet and strong growth prospects in our commercial business, which position us well for strong financial performance in the year ahead. Bill, will now have brief closing remarks, and then we will be ready for questions. Bill?

Bill Lucia - *HMS Holdings Corp. - President, CEO*

Thanks, Jeff. As we look out over the next 24 months, we are very encouraged about our growth prospects based on several factors: the successful business model we have built over the last 30 years; our competitive strengths, including the high ROI our clients achieve; the highly favorable environment for cost containment in which we are operating; the executive team we have built over the past few years to execute our strategy; and the prospect that the Medicare RAC contract renewal process might actually be completed by the end of this year.

As we enter the new year, we are focused on sustaining our traditional government-based business and continuing to expand our commercial presence. Our business model has been refined and improved over the years, but throughout we have focused on finding and correcting erroneous payments for our customers. Our results are consistent and measurable, producing ROIs of 10-to-1 and higher.

We have an expansive national health insurance eligibility and paid claims database, which today gathers information from more than 1,100 third-party carriers and our customers, which includes 45 states and over 215 health plans. Our proprietary analytics, sophisticated technology platforms, clinical depth of physicians and nurses across all specialties, and expertise in reimbursement and payment policy all contribute to our successful and industry-leading cost-containment work on behalf of our customers.

We do operate in a competitive environment, as most businesses do, but believe we have the most comprehensive offering of cost-containment solutions available for healthcare payers. As a result, we have confidence in our ability to maximize 2015 revenue growth and profitability, while simultaneously pursuing long (technical difficulty) opportunities.

We believe our growth prospects will be enhanced this year by a variety of factors, including: optimizing our new commercial sales team; constantly refining our go-to-market product strategy; shortening our ink-to-green cycle time by improving implementation processes; ramping up our acquisition strategy; and utilizing our strong cash flow generation to complement organic growth; continuing to utilize technology and Six Sigma Black belt techniques to achieve cost efficiencies; and maintaining our ability to quickly implement expanded Medicare RAC auditing when the new contract awards are made.

In summary, what I want listeners to take away from this call is an understanding of our commitment to long-term growth and enhancing shareholder value. We have a proven business model, an addressable market of payment errors estimated at over $130 billion last year alone, a very favorable environment in which to conduct our cost-containment business, and a strategic focus on the commercial business opportunities in front of us.

Operator, we are now ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Jamie Stockton, Wells Fargo.

Jamie Stockton - *Wells Fargo Securities - Analyst*

Yes, good morning. Thanks for taking my questions. I guess maybe just a couple of them.

On the state business, it sounds like you are calling for a flat revenue year in 2015. It seems like there should still be some tailwind from Medicaid expansion and then you, I think, indicated that you thought that the reprocurements would see roughly the same scope and pricing. So if you were to put your finger on what is creating some headwind that's keeping that state business flat, what would it be in 2015?

Bill Lucia - *HMS Holdings Corp. - President, CEO*

Thanks, Jamie. This is Bill. I think we said that we are assuming the business would be flat with the same types of either pricing in the procurements or scope of work. Of course, one of the things that happened in 2014 was a number of states had a significant increase in Medicaid enrollment due to the ACA.

So a couple examples were Mass. had at least a 20% -- Massachusetts at least a 20% increase in enrollment. New Jersey had almost a 30% increase enrollment. There's a number of states that had double-digit increases in enrollment.

Those increases we don't expect to see in 2015. So we'll have the impact of those increases not recurring.

There will be some Medicaid expansion, of course and, as CMS estimates, about a 5% increase in enrollment. But since we won't have that significant lift from all of the states, based on the size of the state business we expect that we'll be flat in general. Again, based on the assumptions we made in our comments.

Jamie Stockton - *Wells Fargo Securities - Analyst*

Okay. Then my other question was just on the margin outlook. We don't have all of the numbers around the expense base, ex-Medicare RAC, for the full year in 2014. So if maybe you could give us an update on how the margin improvement effort, ex-Medicare RAC, shook out for 2014 as a whole, and then what you guys would be looking for incrementally in 2015, that would be great.

Jeff Sherman - *HMS Holdings Corp. - EVP, CFO, Treasurer*

Hi, this is Jeff. We haven't provided specific margin guidance for 2015, but we do expect incremental operating cost leverage, which could benefit margins in the year ahead. As we have looked at guidance, we tried to provide as much helpful information as possible about the components of our business that we have sufficient visibility.

So as you look at 2014, we provided non-RAC revenue guidance in the range of 10% to 11%. We achieved that range, though not as we expected we would; but we did achieve it with stronger state revenue growth for the year.

We also expected non-RAC operating margin improvements of 500 to 600 basis points. And on a normalized basis we achieved those results as well.

So I think a couple important points to keep in mind, we did lose $86 million in revenue from the CMS RAC contract. Our adjusted EBITDA declined by only $44 million based on that revenue decline, which included several factors that we noted on this call: the $7 million in legal costs; $5.5 million in AR write-offs; and $4 million in severance.

So I think we responded to the revenue decline. We took out costs, and had to manage through the uncertainty of the Medicare RAC process, and continued to diversify our revenue with commercial sales and revenue growth. So I think we managed costs throughout the year as it became evident that the RAC process would be further delayed.

As we look forward to the year ahead, we expect to see incremental cost opportunities, as we noted. And I think it's safe to assume we are focused on driving efficiencies throughout the organization. So I think we expect to see margin improvement and will expect to see operating cost leverage as our revenue increases during the year.

Jamie Stockton - *Wells Fargo Securities - Analyst*

If we ex- out some of the one-time items that you left in the pro forma numbers for the December quarter, would that underlying cost structure be a reasonable assumption throughout 2015? Essentially an effort to try to hold costs somewhat flat and leverage them to drive margin improvement.

Jeff Sherman - *HMS Holdings Corp. - EVP, CFO, Treasurer*

Yes, I think taking out the unusual items that we talked about -- and legal is one that will have an impact going forward. But growth will have an incremental cost, and we will be making investments in the business on an ongoing basis that we expect are going to pay dividends in the future.

We are investing in a commercial sales force, as Bill noted. We are investing in product development. And we are investing in incremental IT investments.

So we expect to utilize some costs savings to offset a portion of that increased growth. But I think in total we don't expect -- we would not expect to see significant cost growth throughout the year and do think we can achieve further efficiencies as we gain scale.

Jamie Stockton - *Wells Fargo Securities - Analyst*

Okay, that's great. Thank you.

Operator

Ryan Daniels, William Blair.

Ryan Daniels - *William Blair & Company - Analyst*

Yes, thanks for taking the question, guys. Bill, I want to push again on the state revenue to help clarify that a little bit more. I guess two things.

Number one, we've continued to see the Medicaid lives grow very nicely. I think even the data that came out this week showed the December lives growing about 90 basis points from the base level over what we saw in November. So it looks like there is a continued ramp in lives right into year-end, which I think would help growth.

And number two, my impression was a lot of your COB revenue is not right when the lives come in, but maybe more than 50% is on cost recovery and subrogation work which might trail the growth of lives by three, six, nine months. So I still am having some struggle seeing why the state revenue would be flat given those two dynamics, unless there was something one-time this year. Just any color you can provide there, because I'm a little confused.

Bill Lucia - *HMS Holdings Corp. - President, CEO*

Well, let me point to probably two things. One, about 75% of the lives in managed care go into -- or in Medicaid go into managed care. Why we saw a bump in 2014 is in many states they first enter into the Medicaid fee-for-service program.

I think we've talked about this before: that once you've seen one Medicaid program, you've seen one. The state of Georgia I think you stay in fee-for-service for 90 days; then you go on to managed care. In the state of New Jersey, I think you stay in for the first 30 days -- don't quote me, but there's different rules by different states.

So if you take that situation and you have a state -- and we will use as a discussion item New Jersey, that had a pre-to-post ACA Medicaid enrollment growth of 30%; that's most likely not going to be repeated. Then you'll see most of those dollars flow into the Medicaid managed care plans and the claim dollars flow there.

So that's why we are expecting that we are going to see more of the lift from the tail in our commercial business as we go forward, versus seeing it and our state business. Now, we are going to couple that with a competitive year of rebids. So when we balance all that out, we expect we'll be about flat, because we won't see those double-digit growth rates boosting enrollment.

So you're right; we do have a tail. But we have a tail of claims processing typically in the states where we don't have a -- where they don't have a high penetration of Medicaid managed care. There are some states that are fee-for-service only, but those states are typically not the states that expanded Medicaid, with a few exceptions.

Our largest clients are primarily managed care, if not all managed care. So I think that gives a little color of why the large increase this year in enrollment won't be replicated next year; and that the lives, by the time we actually see claims, at least 75% of those lives will be in our commercial database.

Jeff Sherman - *HMS Holdings Corp. - EVP, CFO, Treasurer*

And we do expect that to normalize over time. But the growth in 2014 was just so large on a proportional basis that it impacted revenue more in 2014. We expect over the next year or two, as the Medicaid enrollment plateaus, that growth rate of the low to middle single-digit on the state side, based upon just expenditures growing and our work based on those expenditures, will return to that level of growth over time.

Ryan Daniels - *William Blair & Company - Analyst*

Okay. That's very helpful color. I guess I didn't appreciate that you do get a little bit of pop in state revenue; but those lives can move into the commercial side.

So I guess that's incorporated in the strong guidance there. That makes sense. Two more quick ones.

Just on the AR write-down, I know you discussed it. But is there any more detail you can offer there? Was that RAC-related or anything specific to a customer disagreement?

Jeff Sherman - *HMS Holdings Corp. - EVP, CFO, Treasurer*

Yes, it's basically related to two contract disputes resolved in the fourth quarter, both unusual in size and nature. I'm not aware of any other situations similar to the two disputes resolved in the quarter.

The level of bad debt we have experienced historically is small and has dictated our reserve policy. We have ongoing relationships with these two customers. We resolved the issues and continue to do work with them.

So I don't -- I mean, that's why we called it out: it was large in size and unusual, we believe, in nature in the fourth quarter.

Ryan Daniels - *William Blair & Company - Analyst*

Okay. Then last one, just on the commercial sales. Obviously a lot of news recently on the Anthem data breach. I'm curious if that's driving more RFIs to your organization as larger commercial payers try to bundle to fewer providers, to eliminate those potential data security issues. Do you see that as a potential growth catalysts? Thanks, guys.

Bill Lucia - *HMS Holdings Corp. - President, CEO*

Thanks. That's a good question, Ryan. I think what we've seen in the commercial market throughout this past year -- and as I said, our sales, while we haven't necessarily closed the loop on ink-to-green on all of the sales that we've closed, I think our sales indicate and our discussions with large payers across the nation that they are seeking to use less vendors across-the-board. There is a risk when you use 15 different vendors and you haven't necessarily fully vetted them.

We get audited by all of the large payers in the nation that we contract with, and we've recently become HITRUST certified. That's a gold standard in the insurance industry about health insurance -- about data security.

So we expect that that's going to be an additional tailwind over time, that the payer community will be looking to work with companies that have both a significant security infrastructure but also have been proven stewards of their data.

Ryan Daniels - *William Blair & Company - Analyst*

Okay, thank you.

Operator

Robert Willoughby, Bank of America Merrill Lynch.

Elizabeth Blake - *BofA Merrill Lynch - Analyst*

Hi, good morning. Thanks for the questions. This is actually Elizabeth Blake in for Bob today. I have a couple of questions on slide 7 in your slide deck.

It sounds like a big portion of that 20% commercial growth number is obviously related to Medicaid COB next year. I guess in terms of, if I'm looking at 75% of that growth in commercial being generated from COB in 2014, can you give us a sense for what that number would be in 2015?

And then secondly, you said the average state member is using five tools right now, I guess. Can you give us a comparable number on the commercial side? Thanks.

Bill Lucia - *HMS Holdings Corp. - President, CEO*

Elizabeth, this is Bill. So I -- we expect that we are going to have a relatively similar mix of product by -- across the commercial business. Though our new sales from a volume perspective -- so number of lives perspective -- is outside of the COB suite of products. We still sell COB services; we still sell them to new customers; and we do expansion sales. But more of the new sales are in other lines of business or other product areas.

I guess the other thing that I'd mention about the growth in commercial is we will see an uptick from the lives now, the COB lives, or the lives now impacting our COB product line on the commercial side of our business in 2015. As I mentioned before, the lives shifting out of states if they spend the first month or first few months in fee-for-service.

But that it's hard to predict necessarily where we are going to see all of the revenue growth. We do feel that both from COB, Medicaid expansion,, our internal product yield improvements, and then the new products and services we are layering on under the broad category of program integrity, that we'll be able to achieve the high-level 20% growth rate.

How we get there at the end of the year may be slightly different than how we plan to get there at the beginning of the year. That's why we don't have as much specificity about it. But we are confident in our ability to take the commercial business at a 20% growth rate.

as I mentioned, we had an exit, exiting the year, 18% growth rate in the last two quarters. And that's with having had some delays in implementations that we thought would have been completed and mitigated by the end of the year.

Jeff Sherman - *HMS Holdings Corp. - EVP, CFO, Treasurer*

This is Jeff. The only thing I would add to that is, as we grow more on the PI side, I think it's important to note it's a more complex business. It requires more labor, because we are doing a lot more clinical audits and coding reviews.

And it's lumpy. In terms from -- on a quarter-to-quarter basis it's not a straight line thing. So based upon the work we get, when we get it, then when our billing cycles go out, etc., it can be lumpy.

It's more complex and will require more implementation work, as we've discussed on the implementation side than traditional COB work.

Bill Lucia - *HMS Holdings Corp. - President, CEO*

Then one last thing on the number of products: we are just about over two products per client on the commercial side. Now that's across a broad base of customers, so there could be customers that have one, there could be customers that have six.

But on an average across the membership base, we're at two or just over two. That's why we are very confident about -- as there is a need to focus on companies like ourselves with very comprehensive solutions, that we are very confident about our commercial carriers buying more from us.

Jeff Sherman - *HMS Holdings Corp. - EVP, CFO, Treasurer*

And we did see that number grow in 2014.

Bill Lucia - *HMS Holdings Corp. - President, CEO*

Right.

Elizabeth Blake - *BofA Merrill Lynch - Analyst*

Okay, great. Then just one final topic on that slide as well. It looks like fraud, waste, and abuse was a small portion of your commercial business, obviously, this year; 1% there. But it seems like that's an area in which you've been investing heavily internally, anticipating better growth trends in the future.

So what do you think that can contribute longer-term? And why are you so optimistic about the growth opportunity there?

What do you think this chart would look like five years from now with regard to fraud, waste, and abuse?

Jeff Sherman - *HMS Holdings Corp. - EVP, CFO, Treasurer*

Well, I think we believe it is representing significant opportunity for us. As we are having ongoing conversations both on the commercial and the state side, this product area has gotten a lot of attention. So we think it can be a significant product line for us over time.

That's an area where I think we are going to continue to make investments both internally -- internal investments and, as we said, looking for external acquisition opportunities in that category to help capture that growth. But we are finding a lot of interest in that segment from both commercial and governmental payers.

Elizabeth Blake - *BofA Merrill Lynch - Analyst*

Great. Thank you.

Operator

Bret Jones, Oppenheimer.

Bret Jones - *Oppenheimer & Co. - Analyst*

Good morning and thank you for taking the questions. I wanted to start with the pricing on the state renewals. You said you had four reprocurements hit in the quarter -- or hit so far this year. Can you talk about how pricing has looked for those renewals?

Bill Lucia - *HMS Holdings Corp. - President, CEO*

Well, last -- in 2014 we had, if I remember correctly, District of Columbia, Idaho -- I'm trying to remember some of the -- North Carolina. So there were a couple states that reprocured in 2014.

In general, our strategy has been what we call a bid-to-win strategy. So in the state market, which is 100% RFP-driven, the RFPs really dictate a lot about the strategy on pricing. So it depends on how much weighting is given to price versus cost versus technical qualifications, corporate experience.

And while we believe that it's important to have value-based pricing -- we have the highest return on investment really of any competitor in the space -- that doesn't mean that that's how a procurement will be issued. So we are very careful to make sure that we follow what we believe is a bid-to-win strategy.

So I can't say that there are times when different services within a procurement, the prices may go up; and there are other services where the prices may go down. Net-net, there are also additions to services that come into procurements.

A good example of that was the North Carolina procurement where pricing changed based on the number of services that are in that procurement. But I think we have about 8 to 10 unique services that are in that specific procurement. Some were additional services that were procured this time from the state.

So it's hard to directly answer the question. And at the same time, we also don't want to discuss our bidding strategy necessarily.

Bret Jones - *Oppenheimer & Co. - Analyst*

No, that's fair. I wanted to touch on PCG and the lawsuit there. I understand you can't talk about the merits of the lawsuit.

But if you have engaged in litigation, it means you're able to demonstrate some kind of impact on the business. Are you seeing that in terms of how they are bidding in terms of new contracts that are out there and it's impacting your renewals? Or are we talking about competitive losses? Any kind of additional color there would be great.

Bill Lucia - *HMS Holdings Corp. - President, CEO*

No, I think it would be -- aside from just a policy of not commenting on active litigation, I think it would be inappropriate to discuss the litigation on the call. But I think the most critical thing to remind everyone is that at the heart of HMS we are a data analytics and services company, and we have very important intellectual property. So we take protection of that intellectual property and the contracts we enter very seriously, and we're going to vigorously continue to enforce those through legal action as necessary.

We view any competitor seriously. We actually have for years had competition and welcome it, because it helps us innovate and sharpen our plan to go to market, keeps us making sure that we're delivering the best value. We just don't appreciate unfair competition.

So I don't think I can really say more about that. But I think that's the best answer to the question.

Bret Jones - *Oppenheimer & Co. - Analyst*

Okay. No, that's fair. Then I just wanted to -- one last question I would ask is, I guess I was unaware of some of the state COB impacts of lives coming on at fee-for-service and then later shifting over to managed care. With all the different movement in the products, can we just talk about maybe what your expectations are for growth by product, COB in total? So that way we can offset what's happening between the shifting of fee-for-service to commercial and just look at PI as a whole as well.

Jeff Sherman - *HMS Holdings Corp. - EVP, CFO, Treasurer*

Yes. We haven't really given product-specific revenue growth in the past, I mean as you said, because there is a lot of movement and a lot of moving parts. So we really tried to stick more just on the type: governmental, commercial, etc.

I think over time we will try to refine that. But at this point, with all the moving parts and the complexity of the business, we prefer to keep it at a high level on what we're doing in terms of revenue guidance today.

Bret Jones - *Oppenheimer & Co. - Analyst*

All right, thank you.

Operator

Dave Windley, Jefferies.

Dave Windley - *Jefferies & Company - Analyst*

Hi, good morning. Thanks for taking the questions. Jeff, you alluded earlier in the call to meeting the 10% to 11% revenue growth target for this year but getting there a little bit different way. I'm guessing that the state growth, with the number of lives in Medicaid coming in higher than you expected and for the most part earlier than I think you expected, may have been the outperformer. What was the offsetting underperformer relative to earlier expectations?

Jeff Sherman - *HMS Holdings Corp. - EVP, CFO, Treasurer*

As we started the year, we gave commercial revenue guidance of 25%-plus. We've talked about this in prior quarters.

If you look at the rollout in 2014, it was really the first quarter that was lowest; and then commercial revenue jumped in the second, third, and fourth quarter. So it was really the delay in some of the implementations that we talked about on the commercial side that probably impacted it the most.

I think as we look at 2015, look at our forecasting process, and look at the sales from 2014 rolling into 2015, I think we've got a little bit better visibility there. That's a process that we're continuing to refine, but we do think that 20%-plus growth on the commercial side is a number we can achieve not only this year, but over the next several years, as we look at what we believe are significant opportunities in that space, and our also belief that we are early in our sales process with our newly and fine-tuned sales team to really capture that.

Dave Windley - *Jefferies & Company - Analyst*

Okay. Following up there, and trying to pull several of these comments together, if I look at the commercial line you had, as you mentioned, the low quarter in the first quarter and then pretty darn stable second, third, and fourth. I guess I'm wondering about the Medicaid lives that came into -- expansion lives that came into Medicaid, started in the state, and then moved over to commercial at some point during the year.

If that earlier explanation holds, it would seem that the sequential commercial revenue would have increased more. You mentioned the delay in the lives of the new commercial sales being implemented. I guess I'm trying to wrap several of the comments that have been made on the call together and make them congruent with the numbers I'm seeing in commercial.

Jeff Sherman - *HMS Holdings Corp. - EVP, CFO, Treasurer*

Yes, I think it speaks to a couple things we've said. The complexity of the business and the lumpiness -- so as we move more into commercial side we are going to -- and we bring on new lives, sometimes you have retroactive work that you are doing. So in any one quarter I think it's a challenge for us to do that.

I think as we continue to add sales, as we did in the second half of 2014, and those implementations roll out in 2015, we expect to continue to see an impact from that.

Dave Windley - *Jefferies & Company - Analyst*

On the state side, you mentioned that your expectations there of flat are based on same scope of services, etc. Is there some element of sacrifice in renewals that have already happened having a negative impact on state of revenue in 2015? The carrythrough of recent renewals that is netting what would otherwise be growth, netting that down?

Jeff Sherman - *HMS Holdings Corp. - EVP, CFO, Treasurer*

No, I think we don't have any of the -- none of the reprocurements are out yet for (multiple speakers)

Dave Windley - *Jefferies & Company - Analyst*

I'm talking about things that were already finalized in 2014. Like North Carolina, for example.

Bill Lucia - *HMS Holdings Corp. - President, CEO*

This is Bill. I don't think that we can say that there is an impact from procurements that were completed in 2014 that are necessarily negatively impacting our view for 2015. The biggest factor is that when CMS is anticipating a 5% enrollment increase next year on Medicaid, with 75% of

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them, of those lives, going into managed care, and most of the larger state clients HMS has having seen the big increase in 2014 that we don't expect is achievable in 2015, that -- with the competitive landscape, meaning just that it's a year of 12 reprocurements -- we think those coupled together under the assumptions we've made will have a basically flat 2015.

Now, we haven't taken into consideration states that are potentially going to expand in 2015. We haven't taken into consideration any additional contract extensions. We haven't taken anything else into consideration.

So what we're trying to do is be as -- I guess, in our approach make sure that we are conservative in our approach as we get through 2015 with more clarity. With that said, we have had a very successful 2014 in terms of competitive reprocurements, sales, and rebid across all of our markets.

So we are very confident about our competitive positioning. But I really don't think that we can give a lot more clarity about necessarily how 2015 will roll out on the state side because we just don't think we are going to see the same level of enrollment increases that we saw in 2014.

And those were -- I unfortunately don't have that schedule in front of me, but they were very, very significant across a number of states.

Dave Windley - *Jefferies & Company - Analyst*

Okay, thank you. I'll leave it at that.

Operator

Richard Close, Avondale.

Richard Close - *Avondale Partners - Analyst*

Okay, I just have a couple questions since market is open here. I guess my question, really -- you've provided this 7% to 9% guidance on the call. Why not just put it in your press release or in your slide deck? That's my first question.

Jeff Sherman - *HMS Holdings Corp. - EVP, CFO, Treasurer*

I think we just wanted to give the context of what happened in the fourth quarter and discuss the assumptions around it in more detail. I think no other reason than that.

Richard Close - *Avondale Partners - Analyst*

Okay. Then on the 20% guidance -- or 20% I guess target for commercial, did you break out or can you give some, I guess, feel for how much of that 20% is managed Medicaid?

Jeff Sherman - *HMS Holdings Corp. - EVP, CFO, Treasurer*

I mean, it's been a significant piece of the commercial business; we've said that in the past. We haven't broken that out, but it's still safe to assume a significant portion of it is in managed Medicaid.

But we are also seeing Medicare Advantage and commercial work as well. But I would say it is still safe to assume the majority of it is managed Medicaid.

Richard Close - *Avondale Partners - Analyst*

Okay. Then with respect to competition and the lawsuit, I appreciate you're not being able to talk about it. Can you at least talk to us a little bit about the wins in, I guess, the reprocurement? North Carolina, Alabama, Maryland, DC, what the competitive landscape was in those situations. And I think also, Louisiana was a contract that was up for bid in 2014 as well.

Bill Lucia - *HMS Holdings Corp. - President, CEO*

Let me just talk about two reprocurements to give you a little bit of color. The two most recent reprocurements from a -- going back were North Carolina and Louisiana.

In the state of North Carolina it was a competitive reprocurement. We -- there were at the end of the process two competitors: Public Consulting Group and HMS. HMS won the re-procurement.

The state prior to that was Louisiana. Louisiana, which is I think about 1% of our state government revenue, was awarded to Public Consulting Group. We protested the award. It went through a number of levels of protest; ultimately the state withdrew the award and any work from the procurement. And because the state is migrating all of their lives to managed care throughout the balance of 2015, they decided to not issue a procurement.

So those were the last two. I don't want to really talk through every competitive procurement for competitive reasons. But those were the last two.

Richard Close - *Avondale Partners - Analyst*

Okay. Is there any -- I know when you guys won Minnesota a couple years ago they initiated the RFP, pulled it back because no one competed it against you guys back then, and then put it back out and you guys won even though no one was competing against you. Are there more than one player typically in these reprocurements?

Bill Lucia - *HMS Holdings Corp. - President, CEO*

We have a -- let me take a step back and talk about the market and then the specific products. Our market is cost-containment services for all payers of all types, whether it's federal, state, or commercial.

We have a number of products that fulfill the market needs. One of the products is a suite of products called COB; and in the state world it's called third-party liability services.

Our primary competitor for work in the state market has been states. I mean, it has been state employees; it has been states primarily. Often the Medicaid management information, or MMIS vendors -- Xerox, Molina, HP, a number of those companies.

We have competed with in the past Optum, multiple smaller companies, Public Consulting Group. There is a number of companies -- Emdeon -- there is a number of companies that bid along with MMIS vendors.

So the market is -- the competition across all of our markets is complex. There isn't just one competitor at times, and it depends on how a state procures. States procure through their MMIS contracts; and in a number of states we're a subcontractor to them or other vendors are.

So I think it's a tough question to answer and say is there one or there's two. It has to be structured -- based on the structure of the RFP and how the state is procuring, whether they are procuring directly or they are procuring through another contracted vendor, either an integrated eligibility system vendor or an MMIS vendor.

Richard Close - *Avondale Partners - Analyst*

I guess my point is you guys aren't providing formal guidance actually in your press release, and your citing the heavy rebid. I guess we just here in covering the stock want to understand that and just be comfortable that you don't feel that your competitive position has been -- or has changed at all going forward.

Bill Lucia - *HMS Holdings Corp. - President, CEO*

Richard, I think what I've said in the prepared remarks is we have the most comprehensive and the highest return on investment of any competitor in the marketplace. I've also said that we have litigation because of unfair competition.

I don't want to really comment on that further or blend the two topics. But we have the highest return on investment. It's been measured by states across many of their vendors, of any cost-containment vendor in that marketplace.

I think that if it's a fair procurement that is how we believe our go-to-market strategy is, and that we will fare well in competition with that type of procurement process. I don't know if I can say much more about that.

We are confident in our qualifications. We are confident in our ability to deliver. But I really don't want to comment on the impact of the litigation or what we deem as unfair competition in a market.

Richard Close - *Avondale Partners - Analyst*

Okay, thank you.

Operator

Frank Sparacino, First Analysis.

Frank Sparacino - *First Analysis Securities - Analyst*

Just keep it to one, given the time. Jeff, can you just maybe give us a little bit more guidance in terms of how to think about margins and profitability in 2015?

Jeff Sherman - *HMS Holdings Corp. - EVP, CFO, Treasurer*

I think we've given the revenue side and given overall commentary on costs. I think at this point that's what our plan is going forward.

We do expect to see improvement in 2015. But with a lot of the moving parts we've discussed today, I think we are going to just stick with giving the revenue guidance in terms of our guidance for today.

Frank Sparacino - *First Analysis Securities - Analyst*

Would you be willing to say that margins or EBITDA earnings will grow at a similar rate to revenue? Slower? Faster?

Jeff Sherman - *HMS Holdings Corp. - EVP, CFO, Treasurer*

I think we can see margins improve. I wouldn't characterize it as a relationship in terms of revenue, though. I do think we can expect to see margins improve in 2015.

Frank Sparacino - *First Analysis Securities - Analyst*

Thank you.

Operator

Thank you. I'm showing no further questions at this time. I'd like to hand the call back over to Bill Lucia for any closing remarks.

Bill Lucia - *HMS Holdings Corp. - President, CEO*

I want to thank everybody for attending the call today, and we look forward to talking to you at our Q1 conference call later this year. Thank you.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. That does conclude today's program. You may all disconnect. Have a great day, everyone.
