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HMSY - Q4 2017 HMS Holdings Corp Earnings Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the HMS Q4 and Full Year 2017 Earnings Conference Call. (Operator Instructions) As a reminder, today's conference is being recorded.

I would now like to turn the call over to Mr. Dennis Oakes. Sir, you may begin.

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

Thank you, Chelsea. Good morning, and welcome to the HMS Fourth Quarter and Full Year 2017 Earnings Conference Call. Joining me are Bill Lucia, our Chairman and Chief Executive Officer; and Jeff Sherman, our Chief Financial Officer.

This call is being webcast and can be accessed through the Investor Relations section of our company website at hms.com.

Today's earnings release as well as an investor slide presentation, containing supplemental information, are also available on our IR website.

Bill and Jeff will provide their perspective this morning on our fourth quarter and full year financial results as well as our financial outlook for 2018. Following their remarks, we will open the line for questions. (Operator Instructions)

Before we get started, I want to remind you that some of the statements we are making today are forward-looking, and based on our current expectations and view of our business as we see it today. Such statements including those related to our full year 2018 financial outlook, future performance and our future business plans and objectives are subject to risks and uncertainties that may cause actual results to differ materially. As a result, they should be considered in conjunction with the cautionary statements in today's earnings release and risk factors described in the company's most recent SEC filings, including our Form 10-K.

The financial results in today's earnings release reflect preliminary results, which are not final until our 2017 Form 10-K is filed.

Finally, we may refer to certain non-GAAP measures this morning. A reconciliation of those measures to GAAP is included in both our earnings release and our investor presentation.

We're now ready to begin. Bill?

William C. Lucia - *HMS Holdings Corp. - Chairman of the Board, President & CEO*

Thank you, Dennis, and good morning, everyone. Our fourth quarter financial performance represents a strong finish to the year, and it sets the stage for across-the-board growth in revenue and profitability in 2018.

Total company commercial, state government and coordination of benefits revenues were all at record levels in the fourth quarter. We saw the sequential quarterly rebound that we expected in COB and payment integrity revenue, and both were up double digits compared to the third quarter.

We also finished rebuilding the Eliza sales team in the quarter, so it is fully staffed for the year ahead. And finally, we made additional progress in our effort to put in place and sustain higher throughput in our Payment Integrity business.

We entered 2018 with a favorable macro environment for our business, including an aging population, significant spending growth projected in Medicare and Medicaid over the next decade, and employer-sponsored health insurance is still covering half of the U.S. population despite the growth of those government programs.

Perhaps, most importantly, from our perspective, is an increased focus throughout the entire health care industry on enhancing the consumer experience and improving clinical outcomes by better engaging individuals in managing their own health.

Along with those macro factors, our focus on technology-based solutions aligns with many of the common themes for health care in the United States, identified by key industry observers such as Gartner, PwC and Deloitte. They highlight the increasing influence of artificial intelligence, a growing focus on price transparency, heightened recognition of the importance of social determinants, and increasing impact of Big Data and analytics on the real health outcomes and continuing financial pressure on the health care delivery system due to chronic disease and aging population, expensive drug therapies and unmet social needs.

We believe HMS is well-positioned to take advantage of these multiple health care marketplace tailwinds to grow our revenue in 2018 and beyond. It's not surprising to us that payers are increasingly motivated to gain further insights into the health of their members and to effectively engage them.

5% of the population still generates more than 50% of medical costs. We understand that member satisfaction is a key to retention, and that large employers are demanding more effective cost management and improved HEDIS scores and star ratings lead to higher reimbursements for government-sponsored health plans.

This increasing focus on understanding and engaging the consumer has been building over the last few years. And our acquisition of Eliza in April of the last year, combined with the asset purchase the previous September, fulfilled a significant strategic object objective we had for 2017, to buildout a care management and consumer engagement platform.

This protocol leverages 3 principal HMS assets, data, analytics, and an expensive customer base. And now positions us to partner with customers as they formulate plans to become more consumer-centric in all of their activities.

Rather than our historic contingency fees, this new business can be sold utilizing a more predictable recurring revenue model on a monthly or annual per member basis, which is another big plus.

In order to maximize the growth potential of our care management and consumer engagement vertical, we recently recruited a new leader to oversee all of our population management initiatives. Emmet O'Gara, joins us with over 25 years of experience in the health care payer, provider and employer markets. He has a strong technology and health care analytics background and is based in the HMS Eliza office in Massachusetts.

We believe we now have all of the needed elements in place to cross-sell Eliza's sophisticated analytics, patented technologies and multichannel outreach capabilities to the expensive HMS customer base, and particularly, the midsize and regional Medicaid Managed Care plans.

As a result, we currently expect our first full year of Eliza ownership will be a significant contributor to our projected year-over-year revenue growth in 2018.

Returning now to our heritage business. 2017 sales of Payment Integrity and COB solutions to new and existing customers were strong, with increasing product penetration among the independent blues and regional Managed Care plans.

Based on both recent customer visits and our sales activity, interest in our solutions to eliminate waste and errors in health care payments appears to be undiminished as we enter the New Year.

In fact, many customer discussions have focused on adding additional HMS services. And one of our largest customers recently asked us to come back with a plan to increase their annual savings by 30%.

Recognizing the need for enhanced execution to complement strong sales, we believe we now have the right people and improved processes in place to substantially reduce the backlog of already sold business, expand the scope of our PI work within our existing customer base and continue to leverage our analytics and technology tools to increase productivity.

Jeff will now provide additional detail about our fourth quarter performance and our outlook for 2018. Jeff?

Jeffrey S. Sherman - *HMS Holdings Corp. - Executive VP, CFO & Treasurer*

Thank you, Bill, and good morning. The leverage inherent in our business model was evident in the fourth quarter, as revenue of approximately $148 million resulted in adjusted EBITDA of $40 million and an operating margin of 13%.

Viewed from a market perspective, state government revenue increased by 24% compared to the third quarter and commercial revenue was up over 14% sequentially. We also finished the year strongly from an operating cash flow perspective, with $31 million in the fourth quarter, producing the full year total of $86.5 million.

Investments we made in people, technology, process improvement and innovation throughout 2017 were more evident in our fourth quarter results. The snack bag, in coordination of benefits revenue last quarter to a record $106 million was 17% higher than the prior quarter and contributed to full year COB growth in excess of 8%.

The increase was consistent with the view we expressed on our last earnings call but the third quarter decline COB revenue was timing related and that our yield improvement activities would shine through in succeeding quarters.

Payment Integrity revenue was also up over 12% and Eliza revenue increased 30% sequentially in the final quarter of 2017.

Payment Integrity revenue was higher following implementation of enhanced analytics, which resulted in a substantial increase in medical records requests and findings, beginning in September

(technical difficulty)

quarter. We believe this higher level of activity will be sustainable throughout 2018.

Additionally, using artificial intelligence, machine learning and natural language processing, we were able by year-end to handle the increased workflow with lower incremental costs. We expect to get further benefits utilizing these techniques in the year ahead, which should also contribute to greater audit volume and higher PI revenue this year.

Eliza revenue of $12.9 million in the fourth quarter was in line with our expectations as we finished rebuilding the sales force to full strength. The Eliza and HMS sales teams completed outreach to more than 60 potential Eliza cross-sell customers during the fourth quarter, which has already resulted in several newly signed Eliza relationships.

Understandably, a number of the customer's contacted expressed interest who wanted to renew discussions after completing various year-end activities, so many of those meetings are taking place this quarter. We have also targeted additional customers in the New Year, and that outreach is underway.

COB remained over 70% of total revenue in the fourth quarter, but we expect a relatively faster growth of Eliza, Payment Integrity and Medicare RAC revenues in the year ahead will push 2018 analytical services revenue above 30% of the total, which will be a positive result of the revenue diversification arising from the growth of our care management and consumer engagement vertical.

Adjusted EPS of $0.49 per diluted share in the quarter included a noncash tax benefit of $0.25 per diluted share, as the new corporate tax rate based on the federal tax legislation signed into law last December caused a favorable revaluation of the company's deferred tax balances.

This is an accounting adjustment which arose, because we have deferred income taxes which have future tax consequences due to temporary timing differences between the financial statements and tax basis of assets and liabilities.

Prior to the new federal legislation, we had a net deferred liability carried in our books at an assumed federal tax rate of 35%, which we revalued downward, creating the benefit in the quarter.

Going forward, we currently estimate that our effective tax rate for 2018 will be in the range of 28% to 30%. We will be beneficiaries of the 14% reduction in the federal rate, but we'll also lose certain deductions such as the domestic manufacturing deduction, which will reduce the net benefit.

We have estimated our effective tax rate in a range, because actions which takes place throughout the coming year and reactions to changes in the federal tax law could impact our state taxes. We do expect our cash tax liability will decline this year by approximately $3 million to $4 million, which equates to an adjusted EPS benefit of roughly $0.03 to $0.04 per diluted share.

Three factors cause operating costs to increase sequentially in the fourth quarter, higher bonus accrual due to our strong fourth quarter performance accounted for about $6.9 million of the swing after reversal of about $2 million last quarter.

Legal fees were approximately $3.5 million higher, and subcontractor fees and fringe benefits pushed operating costs up roughly $4 million sequentially.

As we indicated last quarter, some of our executives with significant stock holdings have recently reached or are approaching age 60, which requires accelerated fasting of their equity awards based on our long-term incentive plan. That was reflected in the fourth quarter with stock-based compensation of approximately $7.4 million.

For the year ahead, we expect a higher level of approximately $11 million in the first quarter, as we plan to issue our annual equity grants to employees in March. In subsequent quarters, however, we expect quarterly stock comp to decline significantly to a quarterly run rate of approximately $3 million for the balance of 2018.

Total cost of services for the full year increased approximately $22 million, but that related primarily to Eliza transaction costs and Eliza-related expenses for compensation, information technology, occupancy and amortization of intangibles incurred after the April acquisition.

Turning now to our balance sheet. We amended and extended our existing credit facility in December, which increased our flexibility and supplements our strong operating cash flow.

Though the amended line does provide added liquidity, we generally expect to continue running our business with relatively low leverage. At December 31, we had net debt of less than $160 million, which is 1.3x our trailing 12-month adjusted EBITDA.

As we announced last December, our Board of Directors authorized a new $50 million share repurchase program. We bought back approximately $40 million of our share in the fourth quarter, and we'll continue to do -- to opportunistically repurchase shares with the remaining authority.

Beyond share buyback, our primary capital allocation focus currently is on acquisitions that complement our core business, expand our data analytics capabilities or add to our capacity to detect fraud, waste and abuse.

We are tracking a full pipeline of acquisition opportunities, but we'll continue to be disciplined and apply rigorous diligent standards to any we consider for purchase.

I want to be clear, however, that although acquisitions are potential use of capital, our executives teams focus for 2018 is executing to the fullest on our existing business.

Turning now to the -- our view of the year ahead. Our annual budgeting process utilizing the bottom up approach, during which we identified the elements of our expected 2018 financial performance, for which we believe we have substantial visibility. We characterized our current view with -- of 2018 therefore as a realistic projection based on what we know today.

On that basis, our annual outlook for the full year ahead is as follows. 2018 total company revenue of $560 million to $570 million, which is roughly 7% to 9% growth compared to the prior year. That growth is based on expected double-digit growth in analytical services, which includes Payment Integrity, Medicare RAC and care management and consumer engagement and low single-digit growth in coordination of benefits.

We expect 2018 Medicare RAC revenue of approximately $10 million, so our run rate is slightly above the fourth quarter level of $2 million as more [arms] are approved. This would represent the first annual increase in Medicare RAC revenue since 2013.

Raising the ADR limit above 0.5%, or other action by CMS to facilitate a significantly higher level of auditing would be required to push that number meaningfully higher.

From a market perspective, we anticipate state government revenue growth in the low single digits this year. It will be a relatively typical year in terms of TPL reprocurements, though 3 of our top 10 states, California, Georgia and North Carolina are up for renewal.

The Georgia contract expires on June 30, but California and North Carolina do not expire until December, so no activity is expected on those rebids until the second half of the year.

We expect a usual decline in total revenue from the fourth quarter, which is generally the highest revenue quarter each year, so the first quarter of 2018 will be approximately $18 million to $20 million, though $6 million to $8 million of that decline relates to timing issues with COB revenue over the second half of last year.

As you will recall, we had an unusual decline in COB revenue of $8 million in the third quarter, which we saw as largely timing related, followed by a $16 million sequential jump in the fourth quarter.

As we analyze the sources of that increase, we see a more normalized view of fourth quarter COB revenue of about $98 million to $100 million. We also expect operating margin expansion of approximately 50 basis points, which is largely predicated on projected revenue growth because incremental revenue has a higher contribution margin than the company average, but there are other drivers as well. We will continue to deploy machine learning, robotics and Big Data solutions that further our process automation efforts and to continue to increase efficiencies across all of our businesses leading to yield improvements.

Another expected contributor to margin expansion this year will be the growth of recurring revenue for Eliza solutions, as that model becomes a larger portion of Eliza sales.

During 2017, nearly a quarter of Eliza sales were on a PMPM or PMPY basis, and we expect our percentage to grow over the next few years. We expect approximately $5 million of higher depreciation and amortization in 2018, related primarily to our stepped-up capital investments in technology, which will be a drag on margin expansion.

Moving on to net income. We are projecting $29 million to $32 million for the year, and adjusted EBITDA of $128 million to $133 million.

It is important to remember that net income in the fourth quarter included a $15.1 million tax benefit, which will not be repeated in 2018. Normalizing for that, the expected increases in net income and adjusted EBITDA this year are based primarily on the projected revenue growth and margin expansion.

Capital expenditures this year should again be approximately $33 million, as we continue to invest in our IP infrastructure, build out our Big Data environment and support the ever present focus on data security. Additionally, as we continue to pursue innovations in each of our product verticals, we will have incremental capitalized software expenses.

Prudently managing operating expenses will remain an important focus for 2018 and initiatives to streamline operations and lower operating costs are ongoing, though we will have a full year of Eliza operating expenses, depreciation and capitalized IP costs versus just under 3 quarters in 2017.

We have spoken frequently about ongoing efforts to streamline

(technical difficulty)

we took a number of steps last year to improve the entire process, particularly with regard to Payment Integrity

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much earlier in the sales process to identify and head off many of the client delays we experienced. We continue to find PI implementations this year, with the goal of further reducing the time it takes to produce the first dollars of revenue, developing more PI edits, expediting the customer approval process for those edits, and working diligently to enhance provider communications which minimize network abrasion.

I want to point out that broadening the scope of PI audits or edits we do for existing customers does not require a new implementation, because we already have customer data.

Such scope expansions contributed to the increase in Payment Integrity revenue we saw in the fourth quarter, and will be a big focus for growing PI further in 2018.

With these process improvements in place, our goal is also to substantially reduce the inventory of sold business, both sales completed during 2017 and those we will make this year by the end of 2018 and then to maintain a constant lever going forward.

As a first step, beginning last November, we initiated a concerted effort to reduce projects that were on hold due to client or HMS issues, and we have since cut that list by about 2/3. The project is still on hold or generally due to customer issues, which we continue to address.

We entered 2018 with enthusiasm and confidence in our ability to improve financial performance this year on multiple measures as reflected in the outlook we are providing this morning.

Bill will now have concluding remarks, and then we'll be ready for questions. Bill?

William C. Lucia - *HMS Holdings Corp. - Chairman of the Board, President & CEO*

Thank you, Jeff. We have several important strategic objectives for 2018. First, we are seeking to boost organic revenue growth across all of our products, but particularly Payment Integrity. Second, we will continue to take advantage of technology, innovation and the scalability of our business model to expand margins. Next, we are intently focused on maximizing the cross-sell opportunity of our care management, analytics and consumer engagement platforms within our existing customer base. Fourth, we intend to continue leveraging technology to maximize the value of our data and analytics. Fifth, we will remain -- we will maintain a sharp focus on customer satisfaction and HMS employee engagement. Both annual measures have continued to increase year-over-year, but we set our sights higher again this year. And finally, maximizing total shareholder return, which benefits all of the company's stakeholders, is a top priority in the year ahead.

Our ability to achieve the strategic objectives

(technical difficulty)

successfully meet our performance goals in the year ahead, relies on our innovative and industry-leading cost containment and consumer engagement solutions, but is dependent upon the dedication and hard work of my highly engaged colleagues throughout HMS.

We are intently focused on execution this year, and I am confident the entire organization is up to the task of delivering enhanced value for both our customers and our shareholders.

We are now ready for the first question.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Jamie Stockton with Wells Fargo.

James John Stockton - *Wells Fargo Securities, LLC, Research Division - Director & Senior Equity Research Analyst*

I guess, maybe the first one on COB, since this seems to be so strong in Q4. It sounds like you guys are assuming that a decent amount of that was catch up? And then maybe as we get to Q1 that benefit is going to go away? Can you just talk about how much of the (inaudible) revenue in Q4 was stuff that had slipped out of Q3 versus process improvements or yield improvements that might be more sustainable?

Jeffrey S. Sherman - *HMS Holdings Corp. - Executive VP, CFO & Treasurer*

Jamie, this is Jeff. So we were up 7% in COB revenue year-over-year through the third quarter. And as I said in my prepared remarks, roughly $6 million to $8 million of Q4, we would attribute more to Q3, which kind of gives you a normalized run rate coming out of Q4 of $98 million to $100 million. But again, Q4 always tends to be our strongest quarter for the year, so we'll expect a proportion of decline in Q1 in relation to the numbers I gave for the overall revenue decline. But we are continuing to focus on yield improvement for COB, our Big Data investments, and a lot of our efficiency efforts and technology spend that we're doing is continuing to help us drive further yield improvements. And expect to see some of that flow through to 2018 as well.

James John Stockton - *Wells Fargo Securities, LLC, Research Division - Director & Senior Equity Research Analyst*

Okay. And then, maybe just 1 follow-up, Jeff. The Eliza business, obviously, we didn't have it in Q1 last year. Seasonality in that business from Q4 to Q1, is there any notable step down that rebuilds throughout the year?

Jeffrey S. Sherman - *HMS Holdings Corp. - Executive VP, CFO & Treasurer*

There is, I would characterize Eliza fairly typical to the overall HMS pattern, where the first half of the year is lighter and it builds into the second half of the year, particularly we're looking to help find customers close gaps in care which tends to happen more in the third and fourth quarter, so I would say Eliza's revenue trend overall aligns fairly well with the legacy HMS revenue trend.

Operator

And our next question comes from the line of Nicholas Jansen with Raymond James.

Nicholas Michael Jansen - *Raymond James & Associates, Inc., Research Division - Analyst*

First maybe for you, Jeff. If we think about the visibility into guidance to start the year, this year versus last year, how have you kind of handled the learnings from the 2017 moving parts as you frame 2018? And on that point, just kind of looking at the EBITDA guidance for '18, certainly in '17 you had some one-timers for audit costs and deal-related dynamics, and maybe there wasn't less bonus accrual, but just trying to get your thoughts on EBITDA margin expansion in '18 versus '17?

Jeffrey S. Sherman - *HMS Holdings Corp. - Executive VP, CFO & Treasurer*

Thanks, Nick. So I think first we wanted to put out a number based on revenue in which we had solid visibility on. As a result, we've been measured in our estimate of full year revenue. And really based on a careful analysis that utilized the bottom up approach. I think we have gotten much more granular in our forecasting at both decline and a detail level, and it's been a fair amount of time in 2017 refining our forecasting processes to get there. So I think we have very good visibility coming out of 2017 going into 2018 at a more granular level both at a product and a customer level. And so I think that gives us confidence in the revenue range we put forth. In terms of margin expansion, you are correct. Based on 2017 performance, our overall comp costs related to bonus, although they were higher in Q4, are -- were still down for the year. So we are going to see some higher costs related to that in 2018. And the level of margin expansion we are guiding to is consistent with the measured approach that we are taking in all aspects of our projections for 2018. It's based on financial performance. We believe we have solid visibility on and translating the expectations that we think are both realistic and achievable. So we said a 50-basis-point improvement in our operating margin is achievable, so we do think we're going to get leverage on that. You have a little bit of noise with the stock comp going down from an adjusted EBITDA calculation. But if you looked at our overall EBITDA range, we guided to revenue growth of 7% to 9% and EBITDA, if you just took our EBITDA range, you have 7.5% to 12.3%, adjusted EBITDA is a little lower because stock comp is declining.

James John Stockton - *Wells Fargo Securities, LLC, Research Division - Director & Senior Equity Research Analyst*

Very helpful. And maybe one for you Bill, in terms of what we're seeing with work requirements and in some states testing that out based on some of the changes in RAC late in '17. Just your thoughts on the opportunities there, the risks associated with enrollments, just your broader thoughts on some of the moving parts in the Medicaid landscape.

William C. Lucia - *HMS Holdings Corp. - Chairman of the Board, President & CEO*

Sure. Well, work requirement is depending on the states approach whether it's -- you have to be working or you have to be pursuing work. Anybody who is joining an employer and taking employer-sponsored benefits is a positive for us. So Medicaid member who is now employed and has employer-sponsored insurance is just positive for our core COB business. Of course, at Eliza, we have the capabilities to help individuals whether it's notify them of local job fairs or ask them the pertinent questions about their job search, if the states that's measuring it -- from that perspective. And then, lastly, I'd say that many states -- all states have the access to what's called the health insurance premium payment program. And that's really where Medicaid subsidizes paying the employees portion of employer-sponsored insurance. And some states utilized HMS to manage that benefit. It's a very, very good program, and that Medicaid can pay those premium dollars, make sure that, that employee stays using that much broader and maybe more managed care commercial network, and Medicaid does what it's supposed to do and just pay coinsurance and deductible and act more like wraparound coverage. So all of those from our perspective provide real opportunities for HMS.

Operator

And our next question comes from the line of Sean Dodge with Jefferies.

Sean Wilfred Dodge - *Jefferies LLC, Research Division - Equity Analyst*

So jeff, going back to the comments you made on the improvements in the implementation processes, have most of the big problems there have been sold now? Or maybe how much of what you're doing there, the roadblocks that you've been encountering are actually within your control. I'd imagine these implementations require a lot of coordination or cooperation from your clients. Are you always getting them? Is there -- is that what's been driving some of the kind of friction there that we've been seeing?

Jeffrey S. Sherman - *HMS Holdings Corp. - Executive VP, CFO & Treasurer*

Yes. I think, as we went through 2017 we spent a lot of time breaking down our whole implementation process top to bottom. As I said, in my prepared remarks, as we went through the list and what was causing delays, we certainly determined and really focus on the things that were causing delays and things we could control, and some of that was in our control. I think we worked on that and have been able to reduce those numbers quite a bit, some things we were waiting for. So we might be waiting for data that still might be in the queue. So I do think we made -- we had a lot of success in doing that in 2017, we're always going to have customer issues. Our goal, I think -- the other thing we did is we reprioritized the whole process and looking at both customer needs and the opportunity to drive revenue and what's going to have the biggest impact and realign that in the third quarter as well. So that we know we're getting the biggest bang for the back in terms of the efforts put forth. It is an area where continued investments and technology and adding just more people helps and we've certainly done some of that. And we'll look to continue to do that going forward. But I think the major issues in defining and understanding what was happening, I think we made a lot of progress on, and our goal, as we ended 2018, is to get to a more sustainable level and balance our resources appropriately to keep implementations on an appropriate level and then continue to focus on shortening that time to drive revenue quicker after the sale.

Sean Wilfred Dodge - *Jefferies LLC, Research Division - Equity Analyst*

Okay. And then, maybe one on Eliza. You mentioned a Quickstart for the rebuilt sales efforts there and already having signed a couple of new deals. Those implementations happened pretty quickly, if I remember it correctly. Is that the case and is something we should see beginning to contribute positively pretty early in the year?

Jeffrey S. Sherman - *HMS Holdings Corp. - Executive VP, CFO & Treasurer*

Yes. I mean, Eliza implementations can be anywhere between 45 to 90 days, or sometimes even less. And so we do like the ability to sell and implement fairly quickly in Eliza. So as we think about our Eliza growth in 2018, seeing strong growth there, sales that are occurring in the third quarter and fourth quarter can even be implemented and start producing revenue in 2018. So that will -- that is part of our revenue growth expectations for Eliza.

Operator

And our next question comes from the line of Mohan Naidu with Oppenheimer.

Mohan A. Naidu - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Bill, on the publish and health offerings, can you comment on who you're seeing in the competitor landscape when you're going into the customers? And what has been the customer reception so far given the different priorities they all have, seem to have?

William C. Lucia - *HMS Holdings Corp. - Chairman of the Board, President & CEO*

Yes. So it's very interesting. The -- so we have 3 product offerings. One, of course, very new, which is our member analytic -- risk analytics product. But between Eliza and Essette, they're really different competitors, Essette Care Management suite competes with a number of companies that have been in that space for quite some time, including Casenet and ZeOmega and others. We do believe in that technology, it has the most user-friendly, it was built from a care manager's view and workflow from ground up, and of course, is integrated with EMRs and lab systems and highly functional automated utilization management and preop. So we're very excited about that. And then, of course, Eliza, there's a couple of companies we compete with, [wall talk] might be one that would come to mind. But in reality, as we mentioned, Eliza has significant number of patents around their technology and process, specifically around the work related to both understanding the members preferred method of communication as well as the IVR analytics and special use of IVR that we do. But the interesting thing is applying this -- these 2 and HMS' member analytics software together. And that's what's resonating in the market now is people looking at what we call sort of the Triple Aim. And that's running the analytics to understand the either riskiest members or those who will become emerging risks, which we're able to do, moving them into the Essette Care Management platform, which really access the Care Management, air traffic controllers, so to speak, and of course integrating clinical data so you can better manage them. And then, for those who need intervention, doing that through the Eliza outreach. So we find that while each one of the products may have competitors that the integration of the 3 is extremely compelling, particularly for the small to medium plans, the Care Management providers in the space who maybe taking postacute care risk, many entities providers who take risk. We're a very unique integrated offering.

Mohan A. Naidu - *Oppenheimer & Co. Inc., Research Division - MD and Senior Analyst*

Got it. Maybe on the sales teams that you talked about that is fully staffed now. How much time do you think you need for the sales teams to be fully productive as you expect?

William C. Lucia - *HMS Holdings Corp. - Chairman of the Board, President & CEO*

Well, I mean, so there's a -- part of our model is -- and part of significant growth in the company, of course, I think it's almost an 80 20, just from existing customers. So the beauty of that is we have account managers throughout the nation in both our commercial and government business, who we're out talking about both the Eliza engagement services and the Essette Care Management system on a regular basis. So they are bringing those leads into the company, and then we are assigning sales to that. And then, of course, we have subject manner experts throughout the organization that help on those deals. So I think our model having that expensive account management team helps us get that sales activity generated pretty quickly. And I think in just the -- in 2017 alone, we were able to sell to about 6 HMS -- existing HMS accounts going from small to multimillion member Medicaid plans and to some -- and one was a care management company. So we really are expanding our ability just from within to be able to do up sales, where I think we're going to see a lot of the positive momentum.

Operator

And our next question comes from the line of Ryan Daniels with William Blair.

Ryan Scott Daniels - *William Blair & Company L.L.C., Research Division - Partner and Healthcare Analyst*

A lot of the bigger ones have been asked, a little bit nuanced to you, but on the CMS rack, when both you and your peers have highlighted kind of a lack of momentum there, urgency, so I'm curious if you've had any incremental conversation with CMS about expanding the program and really driving greater recoveries for the trust fund?

William C. Lucia - *HMS Holdings Corp. - Chairman of the Board, President & CEO*

Ryan, this is is Bill. We have -- look, we have ongoing dialogues with CMS, because we view the rack contract as important to protecting the Medicare trust fund. And we believe both the administration and CMS is interested in this as a vehicle going forward. They have some of their own challenges, they have been sued by the American Hospital Association. And so they -- I think they're just going to trend lightly for a while, but they have even slowly have approved new audits. We've submitted a number of new audits and algorithms. And we're processing. So while it's not at the pace it had been in the past, we are doing audits, and we're hopeful based on both the president's budget and the goals they are trying to achieve to close the gap in closing out and proper payments in health care fraud that this will at some point grow. But right now our forecast is based on what we know.

Jeffrey S. Sherman - *HMS Holdings Corp. - Executive VP, CFO & Treasurer*

And I would just add to that, Ryan, I mean, as you look at the last report seeing us put out, there's still roughly $40 billion of payment errors in the last fiscal year, roughly about 10% of claims are paid in error. So we certainly still think there's still a big opportunity there. We came in at 2017 guiding the $6 million to $8 million. We finished the year at about $3 million, so we did have $2 million in the quarter. I think we've been fairly active in submitting audits and new edits scenarios for approval with CMS, and we're seeing traction there. But we are winding down in all contract and ramping up a new contract, and so I think that's part of it as well. But we see the ability to do more audits it's kind of key to the overall revenue potential in this contract. And so if the ADR limit is expanded, we think that could be a good upside for us. And certainly, we're focused on making the case with the 10% error rate, and $40 billion of claims paid in error that the ADR limit should be increased and we're successful in doing that, that could lead to some upside revenue for us.

Ryan Scott Daniels - *William Blair & Company L.L.C., Research Division - Partner and Healthcare Analyst*

Okay. That's helpful color. And then as my follow-up, I know earlier last year, you were talking about maybe more proactively selling some of your program integrity solutions to states as well, perhaps under the Medicaid racks, I believe. So I'm curious if you made any progress through 2017 on that? And if that's still a opportunity for 2018 or maybe less so and more of a sales focus on other areas at this point?

Jeffrey S. Sherman - *HMS Holdings Corp. - Executive VP, CFO & Treasurer*

Yes, Ryan, we did make some progress in 2017 on that, and still expect to see growth in 2018 on that. And so we're really -- we're focusing on the 12 or 13 states that are probably most focused on actually seeing a recovery come out of it. And I think we are having good discussions, and we are gaining some traction and have had some -- and have sold some expanded scope. So part of our revenue and we won't expect to see revenue growth in that in 2018 and obviously, it's a small number, but we are expected to see pretty significant percentage growth in our state rack business in 2018.

Operator

And our next question comes from the line of Matthew Gillmor with Robert Baird.

Matthew Dale Gillmor - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Maybe following up on some of the visibility comments and more specifically, I wanted to ask how the implementation backlog plays into the revenue visibility for '18? You've obviously signed a lot of COB and PI business that hasn't been implemented yet. I was curious if Jeff could characterize the guidance in terms of how much revenue from COB and PI comes from business that's already been signed and waiting to be implemented versus what needs to be signed and implemented in the year. And is that any different in terms of how you construct the guidance in prior years?

Jeffrey S. Sherman - *HMS Holdings Corp. - Executive VP, CFO & Treasurer*

Matt, yes. I would say we have good visibility and a significant portion of our expected revenue growth has been sold and is in -- just needs to be implemented throughout 2018. As I said, obviously, with Eliza, given that we can sell and implement in a fairly short period, part of Eliza's growth is going to come from 2018 sales. But on the legacy COB and Payment Integrity, a fair amount of revenue growth is going to be based on sales that have already been made as well as a continuing to drive yield improvement for existing customers.

Matthew Dale Gillmor - *Robert W. Baird & Co. Incorporated, Research Division - Senior Research Analyst*

Okay, that's helpful. And then, as a follow-up, probably for Bill, but I wanted to ask about some of the third party liability provisions that were included in the recent budget compromise that was signed in the law. It seemed like it strengthened the TPL in the number of areas, especially chip. But can you maybe just give us a sense for how that impacts the business? Is this a really meaningful change? And how long that would take to actually flow into state policy, and ultimately seeing some activity at your level?

William C. Lucia - *HMS Holdings Corp. - Chairman of the Board, President & CEO*

So we're actually measuring now the timeframe that it will take state-by-state. Some states that has managed chip under the single agency umbrella, we had already done some work for from a coordination of benefits perspective, even without the supporting law. But now with the legislation, we are analyzing state-by-state, both fee-for-service and Medicaid Managed Care, which would impact our commercial business, which states have supporting legislation, which ones of our data manage partners will of course just not require any state legislation and just do this because it's good business and it's good for the government, and then roll this out. I mean net-net is incremental to HMS versus our typical baseline. And it's good for the program that chip is now also viewed as a pair of glasses or like Medicaid.

Operator

And our next question comes from the line of Stephanie Davis with Citi.

Stephanie July Davis - *Citigroup Inc, Research Division - VP & Senior Analyst*

This was touched on a bit in the prepared remarks, but could you talk us some of the drivers, the strong commercial growth this quarter? And maybe how you're seeing that demand environment shape up for the coming year?

William C. Lucia - *HMS Holdings Corp. - Chairman of the Board, President & CEO*

Well, the -- so most of the growth is a combination of Eliza and of course, bouncing back from Q3 to Q4 on our Payment Integrity and coordination of benefits. I would say that the growth we expect in the coming year for commercial buyers of our services is going to be organic growth coming out of our COB business, but more continued upsells expansion of audits that we are already doing in the Payment Integrity space for existing logos, the sale of some new logos that are -- and through the implementation or going through the implementation process now are approached to selling through benefit advisory firms to very large self-funded insurers, who are bringing these services to their administrator. And then lastly, net Payment Integrity, and then lastly, the impact of selling as said in Eliza services, the population management and care management services to commercial buyers of our services. That's what we really see as the components, that's built to that.

Jeffrey S. Sherman - *HMS Holdings Corp. - Executive VP, CFO & Treasurer*

I think overall, we still look at the commercial marketplace. Remember in 2016, it was the first year that it surpassed our state revenue. We still think we're in the early innings of tapping into the commercial opportunity in front of us. Adding Eliza in the set Care Management suite, which were entirely commercial focused helps to broaden that as well. We did pick up 2 of the top 10 largest health plans that we weren't servicing with Eliza. So from an overall coverage standpoint, with us being in 23 of the top 25 plans, as Bill said previously, that cross-sell opportunity really represents the significant opportunity for us. And we're going to be spending more time, and then -- both from different outreaches and different ways to approach the market with benefited advisers, starting to tap the true commercial space which hasn't been as focused historically. And saving money is another area where we think we're going to start seeing traction and start to see some traction. And then adding the Eliza and Essette product suite over that, I think we'll expect to see strong commercial growth in 2018.

Ryan Scott Daniels - *William Blair & Company L.L.C., Research Division - Partner and Healthcare Analyst*

It makes sense. And then thinking a little bit more about the Eliza and the Essette acquisition, could you talk about maybe what you're seeing as a low-hanging fruit in this consumerization trend, just given your recent deals?

William C. Lucia - *HMS Holdings Corp. - Chairman of the Board, President & CEO*

Well, there's -- it's -- I don't know about the low-hanging fruit, but I would say that there's a broad swap of what I'd say is a smaller to mid-sized Medicaid plans. Most of them regional, some of them, like in California, county based. That just hasn't had the attention from the more sophisticated vendors and analytics companies like ourselves, to deliver these consumer engagement solutions, whether it's an electronic health risk assessment, which by the way we have a very strong closure rate on, and that's very good to get that data electronically then determine where do you really need to do a physical assessment. So anything between that to member satisfaction and retention to all of the 200-plus programs that Eliza offers. We see that market as a significant opportunity because they're just undeserved. All of the -- obviously, all of the players in this space have focused on the bigs, and Eliza did as HMS did when we first entered the commercial space. But we are now very focused on that 200-plus health plans that sit in that small to midsize base that we believe are underserved, and those are who we are speaking to a daily, weekly basis to sell our Eliza services into.

Jeffrey S. Sherman - *HMS Holdings Corp. - Executive VP, CFO & Treasurer*

And I think having the claims information as a starting point is a big advantage, and then being able to risk stratify patients in a consistent manner across different health plans, we think is very important. And once that is done, being able to use our care management platform with Essette and our outreach platform with Eliza, we do believe we have a unique offering in the marketplace and we're getting I think fairly good traction in our conversations of putting all that together in our total population management approach. And that's where we see I think good opportunities as well.

Operator

And the last question comes from the line of Frank Sparacino with First Analysis.

Frank Sparacino - *First Analysis Securities Corporation, Research Division - SVP*

Just sort of quick, I want to be clear. You haven't given a specific range for commercial in terms of 2018 growth, correct?

Jeffrey S. Sherman - *HMS Holdings Corp. - Executive VP, CFO & Treasurer*

That is correct. But obviously, to get to our revenue growth targets, we've talked about, Frank. What we said state was going to be low single digits. We're expecting double-digit growth for commercial. But that obviously includes the full year of Eliza and the growth in Eliza. But -- overall, guiding to overall revenue guidance of 7% to 9% and have given that commentary on the breakdown.

Frank Sparacino - *First Analysis Securities Corporation, Research Division - SVP*

Great. And then, one last one. On Eliza, maybe, Bill, could you talk about, given the pricing model historically for them was more transaction-driven and you're trying to convert to a more predictable PMPM or PMPY model, what is the risk? Or what's the opportunity as you try to convert those accounts from an economic standpoint?

Jeffrey S. Sherman - *HMS Holdings Corp. - Executive VP, CFO & Treasurer*

Let me start, Bill, can add in. So we said roughly a quarter is in a PMPM model. But I want to stress, we had 8 of the top 10 health claims in Eliza and a lot of transactional work was recurring every year. And so I think our goal over time is to move that more into a PMPM model approach. But generally, we're going to start with transactions, and we're selling Eliza into new customers, it's unlikely we're going to jump into a PMPM relationship first. Generally, we start running a transactional type approach. Our client's fee, the benefits of that, they add more, and we pin to bundle those. It's a bundled approaches, and then ultimately can get to the point where we want to help them both target and run the program throughout the year. And so I think that's where our focus is as we go into 2018. And we are seeing, I think, good traction. But a lot of Eliza's revenue that's transactional in nature, we would still characterize as recurring, because it's done every year by the same customer base, which has been very steady and continues to grow.

William C. Lucia - *HMS Holdings Corp. - Chairman of the Board, President & CEO*

Yes, and I think the other thing that we are very focused on is all of the products that meet that Triple Aim that I talked about, we are focused on selling on a subscription-based model. So we think that's the way health plans like to buy, it's very budgetable from their perspective, it's actuarially were they go, whether it's -- whatever dollars per month, per member, per year, it's very -- we get -- we can get longer term contracts, great visibility in the future revenue, and we think we can provide significant value for those prices. So it starts to derisk some of the things that happened in quarterly swings on the -- continue to see fee-based revenue. So I think you'll see us as we roll out more products in this new vertical for the company focused on subscription-based revenue.

Operator

And I'm showing no further questions at this time. I would now like to turn the call back to Bill Lucia for closing remarks.

William C. Lucia - *HMS Holdings Corp. - Chairman of the Board, President & CEO*

Well, I want to thank you all for your continued interest in HMS. We look forward to speaking to you on our next quarterly earnings call, and wish everyone a wonderful day.

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 great day.