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HMSY - Q2 2017 HMS Holdings Corp Earnings Call

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## PRESENTATION

### Operator

Good day, ladies and gentlemen, and welcome to the HMS Second Quarter 2017 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded. I would now like to turn the call over to Dennis Oakes, Senior Vice President, Investor Relations. You may begin.

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

Thank you, and thank you, everyone, for joining the HMS earnings conference call for the second quarter of 2017. Joining me this morning are Bill Lucia, our Chairman and Chief Executive Officer; and Jeff Sherman, our Chief Financial Officer.

Earlier today, we distributed our second quarter 2017 earnings release via the Investor Relations section of our company's website at [hms.com](http://hms.com). We also posted an investor slide presentation containing supplemental information that we will not refer to specifically in our prepared remarks.

This call is being webcast and can be accessed via the Events and Presentations tab on our IR website, and a replay of the call will be posted later this morning.

Some of the information discussed today will consist of forward-looking statements, including, without limitation, those related to revenue, operating cash flow, operating margin and our future business outlook and expectations. Such statements are based on the company's current expectations, and actual events may differ materially from those expectations.

The financial results in today's earnings release reflect preliminary results which are not final until our second quarter Form 10-Q is filed. We refer you to the company's filings with the SEC for a description of the important risk factors, which could cause actual results to differ materially from those indicated in the company's projections or forward-looking statements.



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All information discussed on this call is based on the information available to us as of today, August 4, 2017. Further, the company disclaims any intent or obligation to update any forward-looking statements as a result of developments incurring -- occurring after today's call, except as required by law.

Finally, we may refer to certain non-GAAP measures this morning. Both our earnings release and investor presentation include a reconciliation of those measures to GAAP. (Operator Instructions)

We're ready to begin now. Bill?

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

Thank you, Dennis, and good morning, everyone. Our second quarter financial performance was solid and consistent with our expectations. We achieved record quarterly commercial revenue, up 30% year-over-year, including revenue from the Eliza acquisition, which closed early in the quarter. Total company organic revenues was 11% higher than the first quarter. We closed the Eliza purchase less than 4 months ago but in that short time have received very encouraging expressions of interest from existing accounts.

At the Eliza Client Summit, which I attended at the end of June, we heard testimonials directly from customers about the value they have received from their work with Eliza. The process of cross-training for the combined Eliza, Essette and HMS sales teams is nearing completion. We have established a reporting structure under a single individual so our sales effort is unified, though we are retaining the separate Eliza and Essette brands.

Beyond the sales organizations, we have identified tremendous talent throughout all 3 companies, and there is an obvious feeling of common purpose and service to our customers. I want to thank everyone who has worked so hard to get us to the point where we are now positioned to sell an integrated solution to our expansive customer base. In fact, we've already begun to actively cross-sell to numerous health plans, at-risk providers and pharmacy benefit managers. We believe we have truly differentiated solutions for current customers or any entities taking risk who are seeking to contain costs, engage their members as active participants in their own care, improve clinical outcomes, increase revenue and achieve regulatory compliance.

Medicaid Coordination of Benefits is our heritage business and remains the foundation which has generated the data, analytics and customer relationships, which we are utilizing to grow our Payment Integrity business. It will also fuel what we expect will be rapid growth in our new health management and member engagement vertical. Despite over 30 years of experience and a market-leading position in Coordination of Benefits, we continue to innovate, increase the revenue yield for customers and make new COB sales. In fact, the majority of new business sold to existing customers in the second quarter was COB solutions.

Beyond COB, there is tremendous growth potential for Payment Integrity solutions with Medicaid managed care, Medicare Advantage, at-risk and ASO plans. And with the addition of the Essette and Eliza health management and member engagement platforms, we've added meaningful white space for growth beyond PI. We believe we can approach this new and expanded opportunity now estimated to total approximately \$1 trillion annually with a solution set which is unique in the marketplace because we now have the ability to approach existing customers whose data is already onboarded, give them the option to identify segments of their membership to target for closing gaps in care or let us provide those targeting analytics for them. We can then risk stratify everyone in their population who meets the identified criteria. Next, we can develop and implement a sophisticated and effective member engagement plan at scale. And finally, we can provide the necessary tools for customers to manage the health of those who need and to track their results.

In addition to expanding opportunities for growth with the recent acquisitions, we are also taking the required internal steps to maximize efficiency, improve product yield, develop and deploy innovative new products, take full advantage of technology and manage a robust pipeline of possible acquisitions to strengthen the growing portfolio of solutions we can offer to our customers.

These behind-the-scenes activities are squarely in pursuit of our key strategic objectives for 2017, which include leveraging our key assets, including our data, analytics, customer base and scalable business model to both grow top line revenue and improve bottom line results; utilizing big data,



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automation and machine learning to create a more nimble operating environment and to enhance our ability to find incremental revenue within our current service delivery model; promoting internal innovation to continue streamlining business processes and developing new products as well as working collaboratively with customers to refine existing products and jointly develop new approaches to cost containment, health management and member engagement; attracting, growing and retaining the high-caliber talent we need to manage our increasingly complex business, which our internal measures of success tell us is succeeding as employee engagement scores continue to improve annually; and finally, prudently deploying capital is always an important strategic objective.

We are, for example, creating a big data environment, which is a necessity given the exponential growth of data throughout the health care system and the ever-expanding size and complexity of our customer interactions. As you know from our stepped-up capital expenditure plan for 2017, we are investing in advanced technology and automation to promote long-term growth. The enhanced infrastructure we are building allows HMS to ingest source data from our clients and trading partners much more rapidly. We then utilized the increased analytical horsepower to create and assess improvements to our core COB and PI products and to quickly and easily extract the relevant data from the huge files we receive as often as daily from some customers in order to maximize results.

We are also in the process of deploying robotic process automation across the HMS enterprise in order to better serve customers and to reduce operating costs. Fully implementing all of the components of the comprehensive big data environment we envision is a multiyear project. We are seeing some immediate results. But the good news is that our investment should continue to pay significant dividends over the next 2 to 3 years as the rollout is completed.

In order to maximize the short-term benefits from our investments in technology, we have prioritized the client and product focus for 2017 in those areas we believe we'll have the greatest impact in terms of current year revenue. That includes our Payment Integrity product line and our entire ink to green process of converting closed sales to client savings and HMS revenue.

Employing our new technologies for 2 large national Medicaid plans, for example, allowed us to successfully complete implementation in the second quarter of 10 separate COB and PI projects in multiple states in about 1/3 of the average time it has taken historically. We do have more work ahead, but we are making measurable progress which will be particularly evident from a top line perspective in the second half of this year.

Increasing the revenue yield in COB and PI is another target of our technology initiatives. We are using machine learning, for example, to streamline the time it takes for a nurse or coder to review a medical record. We're also continuing to hire Six Sigma engineers, experienced data scientists and other individuals whose expertise has added immeasurably to the sophistication of our analytics and our ability to react quickly to ever-changing business rules, reimbursement methodologies, provider contracting approaches, health plan designs and payer adjudication processes. Not only will this team of experts help boost our responsiveness to our customer needs. They are also leading the effort to capture the full value of new technology to generate incremental revenue from previously sold and fully implemented business.

While those activities are under way, our sales team is halfway through another banner year with additional products sold to current customers covering approximately 22 million lives and nearly 1 million new commercial members added through the first 6 months. The second quarter included an important add-on sale of Eliza services to one of their existing customers, which was also an HMS customer, covering approximately 600,000 lives. This work is a full outsourcing of targeted analytics and member engagement, which will be built based on a SaaS recurring revenue model.

In sum, we believe we are well positioned for growth on several fronts, from cross-sells of health management and member engagement solutions to increasing the yield on our existing product suite, to expanding Payment Integrity sales through Medicaid managed care, Medicare Advantage, at-risk and ASO clients, to the internal development and sales of innovative new products, to leveraging all of the efficiencies which can be achieved in a big data environment and finally, to further expanding via acquisition. These multiple avenues of growth are what add to our confidence about a strong finish to 2017 and the reason we are excited about 2018 and beyond.

Jeff will now dive into some of the key numbers for the quarter. Jeff?



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

Thank you, Bill, and good morning, everyone. The current quarter played out essentially as we expected. A strong second half for our traditional cost containment work is consistent with our experience in prior years, and what we already know is in the pipeline for incremental revenue between now and year-end gives us added visibility.

Second quarter Eliza revenue to HMS of \$7.6 million was a bit lighter than we anticipated. But for reference, their actual revenue for the full quarter, which included the first 2 weeks of April before the deal closed, totaled approximately \$10 million. Additionally, Eliza customers often do not focus on identifying and closing gaps in care until the third quarter. So a meaningful step-up in the back half of the year is consistent with our traditional revenue patterns.

Total company revenue in the second quarter was about 17% higher than the first quarter, including the Eliza revenue. Organic growth of approximately \$12 million compared to the first quarter was consistent with the roughly 10% organic growth we projected. Through year-end, we expect total sequential revenue growth of 10% to 11% in both the third and fourth quarters, including Medicare Eliza revenue.

Year-over-year growth of nearly 10% in our Coordination of Benefits business in the quarter for both state government and commercial customers was very encouraging and compelling evidence of the ongoing impact of process improvement initiatives started in 2015. State government revenue was roughly flat year-over-year, but the second quarter of last year included a onetime acceleration of approximately \$5.5 million of subrogation-related revenue, so a tough comp. Adjusted EBITDA of \$30.5 million was a significant move up from the first quarter and reflects the leverage-ability of our business model as revenue increases.

We have not yet seen the list we expect in Payment Integrity, though it was up modestly from the first quarter level. As discussed last quarter, we have taken a number of steps to improve and accelerate PI data onboarding, analytics and implementations. We made meaningful progress in the second quarter compared to the prior quarter and the year-ago quarter, which resulted in significantly more Payment Integrity projects going live. Specifically, we completed more implementations overall, including 3x as many PI projects as in the first quarter, and reduced overall reimplementations, where we are simply preserving existing revenue by nearly 1/2.

The reason that implementation progress has not yet produced substantial incremental PI revenue is that customers that did go live in the second quarter will not produce revenue until at least the third quarter as an additional 90 to 120 days are typically required to complete the following steps: the scope of auditing needs to be finalized by the customer; our analytics are run and medical records are then requested, returned by providers and reviewed, a process which usually takes 45 to 60 days; and lastly, our findings are then communicated to the provider, which is the point at which revenue is ordinarily recognized.

We continue to move more of these processes into the final stage of the sales cycle in order to reduce the total time from ink to green, but interaction with the provider networks is a factor which can only be compressed so much and does not exist with COB, which, therefore, is a less elongated implementation. Knowing the increased volume of medical records, which we have requested over the last 90 days, however, gives us heightened visibility into PI revenue in the second half of the year.

Moving on to Medicare RAC. We did receive our first batch of claims in May, so we're able to begin the auditing process. Initial requests for medical records in order to conduct complex reviews have gone out and should produce the first dollars of revenue over this summer. We were also able to begin some automated reviews recently. And following approval by CMS of our provider outreach plans, we began work in the Mid-Atlantic States which were added to our Western region in the new contract. Revenue should begin to be recorded as a result of these combined activities, but we do not expect more than \$1 million to \$2 million next quarter.

Following the Eliza acquisition, we have reconfigured our presentation of revenue by market and product in both the earnings press release and our investor deck. With regard to products, we will provide revenue for Coordination of Benefits as in the past, and we have created a second category called analytical services by grouping together Payment Integrity, Medicare RAC and health management and member engagement revenue currently generated by the Essette and Eliza platforms. For at least the balance of this year, we will continue to provide the revenue detail for each of the 3 components of analytical services so comparisons can be made to prior periods.



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Our operating margin improved significantly in the quarter. Excluding the Eliza transaction fees and incremental audit fees in connection with the 10-K filing, which together totaled about \$3.9 million in the quarter, operating margin was approximately 13.6%. With a meaningful revenue increase anticipated in the second half and incremental revenue coming at higher-than-company average contribution margin, we continue to believe we can achieve full year margin improvement of 125 to 150 basis points, normalizing for the first half transaction and audit fees.

I want to point out that since we intend to make future acquisitions, we do not view acquisition-related fees and expenses as nonrecurring for purposes of calculating adjusted EBITDA or adjusted EPS, which we reported as \$0.16 in the quarter. Similarly, though much higher than usual, the incremental \$400,000 in fees this quarter incurred on the audit for our 2016 10-K were treated as normal operating expenses for the purposes of our adjusted EPS calculation. These 2 items combined had a negative impact on GAAP EPS and adjusted EPS of \$0.03 per diluted share in the quarter.

Overall operating expenses in the second quarter did increase approximately \$13.8 million compared to the prior year quarter. But the difference relates primarily to the transaction and audit fees together with the incremental compensation and other expenses associated with Eliza, which together totaled approximately \$12.9 million in the quarter. In other words, operating cost on an apples-to-apples basis were roughly flat year-over-year, which was a key contributor to the margin improvement we saw this quarter.

With regard to current liquidity, we began rebuilding cash after deploying approximately \$130 million for the Eliza acquisition in April. Quarter-end cash was \$51 million, helped by operating cash flow in the quarter of \$21 million. We drew down approximately \$42 million on our existing credit line for the balance of the Eliza purchase price such that our outstanding balance is now \$240 million, which is just over 2x levered based on a trailing 12-month adjusted EBITDA, which is the leverage measure used for the terms of our credit agreement.

Together with strong cash flow, we currently have adequate liquidity for additional acquisitions, and acquisitions remain our priority for capital allocation. We are actively looking at a number of potential purchases which could expand our data analytics capabilities or further build out our new health management and member engagement vertical.

We are intently focused on completing the full integration of Essette and Eliza but realize we have to simultaneously make our continued interest and presence in the market known if we are to stay in the loop on deal flow. We are also continuing our proactive outreach to companies of interest which have not put themselves up for sale. CapEx in the quarter was approximately \$7 million, and the year-to-date total is approximately \$15.5 million. We expect the slightly higher case of spending over the balance of the year, including Eliza capitalized software expenses of approximately \$5 million so that full year capital expenditures will total approximately \$33 million. Our balance sheet at June 30 reflects incremental goodwill and intangible assets added as a result of the Eliza acquisition.

Our effective tax rate in the quarter was higher than expected due to the fact that a portion of the transaction fees in connection with the Eliza acquisition are not deductible for tax purposes. The result was an effective tax rate of approximately 46%. Absent the impact of those transaction expenses, the rate for the quarter would have -- had been approximately 38%, which is close to what we expect the effective rate will be for the full year when we calculate taxes at 12/31. The higher tax rate this quarter negatively impacted GAAP EPS and adjusted EPS by \$0.01.

Bill will now have brief concluding remarks on the Senate action regarding the Affordable Care Act, and then we'll be ready for questions. Bill?

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

Thanks, Jeff. The Senate votes last week appear to make clear that proposals to significantly cut the Medicaid program are not likely to gain majority support in the Senate. It now seems there will be hearings at some point to explore various fixes for the exchanges and certain other aspects of the ACA which are viewed as broken or failing and that bipartisan solutions will be needed to get anything passed in the Senate.

Finally, with the priority apparently shifting to tax reform and potentially infrastructure spending after that, it is hard to envision any meaningful progress on health care for the balance of this year. Of course, next year, there are midterm elections and that [Med] has its own set of dynamics in connection with potential legislation.



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We have said from the outset that we expected congressional action will ultimately have little or no impact on our business, expect possibly a modest increase in state government interest in our cost containment initiatives if federal Medicaid reimbursements declined. The most recent actions in the Senate and ensuing commentary reinforce that view. As we look ahead to a strong finish to 2017, we do so with confidence in our operating model, strategic direction, expanded addressable market with the added health management and member engagement solutions we can now offer, along with a fully engaged workforce.

Our new ability to leverage data and analytics to identify, manage and engage members resulting in better clinical outcomes and lower costs is an attractive offering for all payers, but it is also essential for the long-term viability of our health care system.

Operator, we are now ready for the first question.

### QUESTIONS AND ANSWERS

#### Operator

(Operator Instructions) And the first question is from Nicholas Jansen of Raymond James.

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

Two questions for me. First on Payment Integrity, certainly some improvement relative to 1Q as you brought down the implementation queues. But just want to get your sense of where we sit today, how should we be thinking about the sequential process on that specific line between 3Q and 4Q and the level of visibility you have in terms of achieving the targeted guidance that was, I believe, reiterated?

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

Thanks, Nick. This is Jeff. So a majority of our health plan sales over the past year have been PI products. And as we said, they are more complex to implement than the COB contracts and usually takes longer before they're revenue-producing. I think client collaboration and the availability of IT and other customer resources are critical factors in the process. PI revenue can be uneven from quarter-to-quarter as clients' plug holes and we discover -- and we develop new edits. So I think we've done a good job of developing new edits in terms of generating more medical record requests, as I said in my prepared remarks. So I think we have good visibility of the data that's in the pipeline and medical requests that's in the pipeline. So as we talk about our 10% to 11% sequential revenue growth in Q3 and Q4, PI is going to be an important component of that.

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

Great. And then my follow-up would just be on the Eliza transaction. Certainly, the tone sounds great about cross-selling opportunity, but the revenue did fall a little bit lighter than what you were expecting in the quarter. So just trying to kind of bridge what you're assuming in the back half of the year from a contribution perspective there. Does the \$35 million full year number that you talked about last quarter still hold true? And if we think about that growing next year, where are the key cross-selling opportunities that you think about from a first wave perspective?

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

I'll start and Bill, if you want to add anything. So in terms of the \$35 million we talked about in the first quarter, we still do think that's achievable for Eliza for the year. Eliza's revenue model historically has been back-end loaded as companies look to close gaps in care and drive improved Star ratings and HEDIS rating. So the typical seasonal pattern for Eliza has been more back-end loaded for the third and fourth quarter. And we expect that's going to play out this year as well. I'll let Bill talk about some of the initial interactions. But I'd say, so far, we've had very positive receptivity from our legacy HMS customer base for the Eliza products.



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

Yes. So thanks, Jeff. Our focus is on the significant large number of Medicaid plans that HMS has under contract, particularly the midmarket plans and regional plans. We have, I'd say, 90% of those plans across the nation under contract. They are underserved by other providers of this service. We have their data. We understand their past HEDIS and Stars ratings and other scores. We can quickly find the gaps in care that they have to close. And so that's our focus, is getting out to this very large group of regional Medicaid plans that Eliza has had very little penetration in. The other areas that we're finding some interesting opportunities are with PBMs, health companies and the employer space. As you know, HMS has a segment that serves employers, mostly distributed through benefit advisory firms, and we're starting to get some early interest in that arena. So we think that we've got a full court press throughout the company on selling Eliza services into our existing customer base, and early response has been very positive.

**Operator**

The next question is from Jamie Stockton of Wells Fargo.

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

I guess, maybe the first one, Jeff. As far as Eliza is concerned in cost in Q2, I think you had the roughly \$3.5 million of transaction expenses that it seems like, you left in the numbers. I saw a footnote in the presentation that made it sound like the expenses for Eliza were higher than the revenue during the quarter. So just as we think about sequentially like the impact on profitability in Q3 as kind of things normalize here, could you give us some sense for what the magnitude is?

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

Yes. I think overall, we've said, Jamie, that we expect Eliza margins are in line with the company's historical margins on an EBITDA basis, I would say. So with an acquisition taking place and certainly, the seller wanting to make sure all revenue was in, we saw more revenue in the first half of April before we acquired Eliza and certainly don't -- didn't see a proportional relationship with cost with that revenue. So I think as we go forward, we expect that the Eliza transaction will be accretive in the first year of operations. Obviously, when you go through an acquisition, we do have to kind of revalue assets, intangible assets, et cetera, so that will have an impact on intangible expense. And when we file our Q, you'll see the breakdown between goodwill and intangible. And in fact, you can see it in our balance sheet as well based upon the press release. But we certainly are optimistic and think we'll see improving margins for Eliza and that on an overall basis, it will be consistent with the company's kind of average EBITDA margins going forward.

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

Okay, that's great. And then maybe, Bill, one of the more interesting things about Eliza, aside from the core solution when you announced the deal, I thought, was the notion that some of their data might actually help you improve your Coordination of Benefits hit rate. You've had this business for 3 or 4 months now. Can you talk about whether you -- once you've gotten underneath the hood, is there data there that you feel like will be able to really move the needle? And like when might we start to see the impact of that?

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

So that's a good question. We actually have initially focused on growing Eliza and growing the product line through our existing customer base and then, of course, shoring up the sales initiatives to make sure that we are impacting all the markets that Eliza can serve. So that's our -- that's been our first goal. But the second wave, and we actually have people looking at this, is what are the areas that their technology can add value to HMS? And there are a number of them. One, of course, is using this third-party data to perfect data in the HMS database. As you might guess, data





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that comes from Medicaid programs is sometimes flawed. The third-party data that Eliza brings in is able to update that. So we get better addresses for people which would impact our hit rates. We haven't, as of now, done anything to impact the core COB from that perspective. But I'll just draw out a couple of other areas where we think there's great opportunity to use Eliza's services or their technology. So in our subrogation arena, we now by contract, send out what are called trauma code mailers. You may have gotten one in the mail when you've gone to the doctor and it looks like it's an accident. It's a piece of paper, right? Well, we can do that through Eliza's IVR or SMS outreach and save significant postal cost. That's just one example. In our premium assistance program, we can do automated outreach to members. So we are looking across the landscape for those kinds of synergies to impact the existing products. But first and foremost is we want to shore up Eliza's sales to our existing customers because we think that's the biggest bang for our buck, and then we will move our engineers on to the -- how do we apply Eliza to HMS' core business.

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**Operator**

The next question comes from Mohan Naidu of Oppenheimer.

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

Maybe Bill, on the implementation side, you noted that you're doing faster implementations, nearly 1/3 faster. Is that predominantly because of automation and increased use of streamlining services? Or are you adding more resources? And how does this change your pace of converting new clients to revenue?

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

So we -- it's a combination of both focusing on the right implementations at the right time, right? So we had a little discussion about this last quarter, but those clients that are going to have an impact in the near term versus working on a reimplementation of a conversion that's happening in 2018 is using our new technology. So it's the big data that is now implemented across about a half a dozen clients primarily focused on Payment Integrity but also on COB to improve yield. It's using new technology to get at that data lake faster. And it's also just some internal restructuring to put new key people in charge of the implementation process for PI. Now PI is still one of those things where once we get up and running, you still have about 90 to 120 days from the time you actually have a finding and send that out until the time you're actually generating revenue. So there's implementation and then there's lag after implementation, but the bottom line is -- the good news is we have the inventory, we have the willing customer base and we have the claims data to be able to show them where they have problems. And we continue to shrink, through technology, through this restructuring and through reprioritization, the time from ink to green. And I think the example I gave in my prepared remarks was one that really helped us in Q2 get a collapsed time frame for 2 clients across 10 states.

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

Got it. That's very helpful. And I think you made some comments around acquisitions. Are you still focusing more on these health management and member engagement type of solutions to expand your portfolio there or are you looking beyond that?

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

Well, we're looking -- look, we have -- as we've discussed, we've now kind of collapsed our reporting into 2 verticals, so to speak. COB, which there aren't a lot of COB businesses to acquire, so I wouldn't expect that we'd see a lot of activity there other than maybe technology that would help support us across the enterprise. But in reality, we are looking at both Payment Integrity and health management, health management solutions as well as data analytics that supports all of those services. So we have a robust pipeline from small to large and an active program, and we're very excited about the opportunities that come our way. As I've said in the past, we kiss a lot of frogs. We are being very careful about the companies that we buy and -- but they have to have a good fit and they have to come with a strong management team.



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

And I would just add, Mohan -- this is Jeff. I mean, as we said in our prepared remarks, I mean, the focus -- we are really focused on the full integration of Essette and Eliza and our go-to-market strategy on that. And so having one individual lead the sales effort of that, under our sales leadership, under Doug Williams, I think we're expecting to see good progress there. But as Bill said, we also have to continue to look for acquisition opportunities. We have a dedicated group of individuals doing that and so that work continues.

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**Operator**

The next question is from Matthew Gillmor of Robert W. Baird.

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

I wanted to ask about the Eliza pricing model. And I think historically, they've been priced on a program basis. Bill mentioned a large sale that was on a subscription basis. So can you update us on where you are from a pricing standpoint with Eliza? Will you be selling all new deals on a subscription basis? I'm mostly just trying to get a sense for how aggressive you're moving in that direction and how we should think about that impacting the revenue seasonality in the future.

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

Thanks. I would say Eliza has an evolving revenue model, which really we're intending to retain. They had a much, much larger share of their revenue under a recurring model versus our -- versus the Essette acquisition. And so I think we need to be flexible and responsible to customer needs, particularly for new sales. The new sales often start on an activity-based program, and then those activity-based programs get expanded into several programs. And then ultimately, I think with the value proposition delivered, I think clients kind of ultimately see that doing -- having Eliza do the targeted analytics and the full comprehensive program is more cost efficient and effective for them and then transitions into the recurring revenue model for us.

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

Okay. And then one clarification for you, Jeff. I think you mentioned the expectation for 3Q revenue to be, I think, 10% to 11% higher than 2Q and then the same for 4Q inclusive of Eliza. Is that what you said?

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

That's correct.

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**Operator**

The next question is from Richard Close of Canaccord Genuity.

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**Richard Collamer Close** - *Canaccord Genuity Limited, Research Division - MD and Senior Analyst*

With respect to the investments, big data that you're doing right now, Bill, I think you talked a little bit about seeing results, and I'm curious if you could provide a little bit more in terms of the results that you've seen so far on those investments. Is it really more, I guess, less expenses, better efficiency for HMS? Or is it tilted more towards increased revenue opportunity? I assume it's some combination. But if you could give us your thoughts on better profitability based on those investments versus, I guess, higher revenue growth.



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

Well, it is a combination of both. I mean, initially, our focus is on -- with big data is getting at the data faster to enable it to find the savings for our clients, which, of course, generates revenue for us. So the initial focus is on revenue. The ultimate -- there will ultimately be a cost savings because we will have one data ingestion warehouse that all of our systems feed from, right? So there's a cost savings that will happen across the board. And then the other technologies I've talked about are full speed ahead in both natural language processing, robotic process automation. Those are both -- they're a combination of both increasing yield and revenue but also heavily focused on improving operating costs. So we expect to see initially yield and top line revenue, but we're expecting strong bottom line results from the technologies we're bringing in. But again, as you know, a carefully laid out technology plan is a multiyear endeavor, but we're already seeing results, and we expect them to continue to yield over the next 2 to 3 years.

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

It also helps us to target our yield activities more effectively. So we're going after higher-value claims in terms of our review process. So I think that's an added benefit as well.

**Richard Collamer Close** - Canaccord Genuity Limited, Research Division - MD and Senior Analyst

So as you guys talk about improved yield and I understand it's a multiyear process, is that something you think about in terms of -- that you're targeting maybe a certain basis point improvement or incremental growth on it, like it will add 100 to 200 basis points to organic growth? Or how should we think about it like that?

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

I mean, we do look at it on a program-by-program basis and track it. It's reasonably accurate, but it's not perfectly accurate. And so I think we think about it on specific actions that we're taking and how do we track the changes of that, and we have seen good progress on that. I mean, certainly, as you look at the COB revenue in the quarter, it was up strong, and some of that certainly was attributable to yield. So I don't know that we would try to quantify it in a percentage in terms of a discrete line item, but we do include it in our overall revenue guidance that we provide.

**Richard Collamer Close** - Canaccord Genuity Limited, Research Division - MD and Senior Analyst

Okay. Another question I had was, I think you mentioned in your comments that a majority of new business sold to existing clients was COB services. How much of it -- is that much of a change or if you can just provide any additional details on that comment?

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

In the second quarter it was more heavily weighted towards COB. As we said throughout last year, it was much more weighted towards Payment Integrity. So I would just call that a quarterly anomaly in terms of Q2. But it does still say -- suggest we have opportunities to increase COB sales through additional expansion of services.

**Richard Collamer Close** - Canaccord Genuity Limited, Research Division - MD and Senior Analyst

Okay. And I think last quarter...



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

We got to move on because we got other people in the queue, so...

**Operator**

The next question is from Frank Sparacino of First Analysis.

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

Jeff, maybe for you, just on Eliza. Can you give us a sense of what the growth was in Q2 or the first half of the year?

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

I would say, without get into a specific quarter, I would say it's been a double-digit grower over the last several years on an annual basis. Obviously, I wouldn't comment specifically on anything happening in Q2. With an acquisition going on, there's obviously some distraction that takes place with an acquisition. So I wouldn't want to provide any -- I wouldn't want to have misleading outcome from Q2. But I would say overall, it's been a double-digit grower over the last several years. And certainly, we think we can continue that growth rate, and it's a growth rate we expect to see along the lines of our commercial health plan growth rate.

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

And just maybe one follow-up there, I just want to clarify. So you talked about \$10 million of revenue in the quarter for Eliza, I guess, on a pro forma basis. But was there some deferred revenue haircut that you took in the quarter as well?

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

I mean, with an acquisition, depending on the accounting treatments, there's always some revenue adjustments with an acquisition. But I think overall, \$10 million was probably the pro forma revenue considered for the quarter. And again, as I've said, their historical revenue pattern is more back-end loaded and we expect that to be the same for 2017.

**Operator**

The next question is from Ryan Daniels of William Blair.

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

Bill, you mentioned cross-training was near completion for the sales team for the analytics platform and I guess, a few questions there. One, do you see that more as a 2018 driver, given some of the seasonality in the business? Or do you think some of that could contribute to sales in the back half of '17? And then also, is the early feedback from customers on kind of a comprehensive bundle of solutions? Or is it more likely to be more modular purchases like a land and expand strategy?

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

Well, so it definitely will be part of 2017 because it's this time of the year where typically, our clients are attempting to close gaps in care, improve their HEDIS measures, and that is our -- our go-to-market is basically to say if you do x, y and z with us, we will be able to raise these scores and it's



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worth x million dollars of revenue to you. So that's very compelling to customers. So definitely, it's impacting 2017. Eliza does not have -- it's not like Payment Integrity where after you've loaded the claims, you've got tons of analytics, you have clients kind of measuring your progress of getting things out to your providers. I mean this is very quick. By the time we do the implementation, it's very quick to revenue. It's probably, in all of our business, the fastest. So we're -- we believe it's going to have an impact in 2017, which is why we have full court press across the company from all sales people, all the way to the executive team to sell Eliza. The other is we think, long term, we just are opening new markets. As I mentioned, the employer market is ripe for this, particularly the large self-insured employer through the benefit advisory firms. So we're finding new opportunities for Eliza that I think we'll -- while 2017 is a strong focus for us right now because of the sales activity we're doing, we expect that we'll be opening new markets for the company in 2018.

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

Okay, that's helpful color. And then a big picture question. This quarter, a lot of other entities have talked more about the qualified entity program and the data they can capture from Medicare claims. And I'm curious, maybe you have enough your plate with everything going on. But longer term, do you see value in that as well, especially in care gap closures and as you think of Medicare risk adjustment, things of that nature? Is the QE program something that HMS is likely to participate in?

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

Yes, I think -- Ryan, I think I would say couple of things. As part of our TTP, trusted third-party, contract with Medicare, we certainly see some opportunities to grow some revenue there and using the unique data set that we have. So I do think we have opportunities in what we call in kind of our federal program to expand revenue in some unique and interesting ways, and we're having some additional discussions with regards to just Medicaid data as well to do that. So I do think we have opportunities there, which is probably -- we'll probably focus more of our efforts there in the short term.

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**Operator**

And the next question is from Steven Valiquette of Bank of America Merrill Lynch.

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**Steven J. James Valiquette** - *BofA Merrill Lynch, Research Division - MD*

So you guys mentioned in the press release at least some progress on commercial PI implementations. A couple of days ago, though, we saw one of your commercial market competitors also talk about some implementation delays in the customer base and their stock seemed to take a pretty big hit on that. I was wondering much of this collective delay may be the customer base hitting the pause button on spending patterns this year, whether due to uncertainties in the health care marketplace or whatever reason versus just the notion that these are just one-off decisions. Like any thoughts would be helpful especially since you guys are sort of calling for a need to have a big ramp in commercial res in the back half of '17 in particular?

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

Well, I think -- thanks for the question. I think, we've talked about implementations and implementation delays and challenges with customers turning things on and off and provider exceptions or exclusions where they say, "I'm negotiating with this chain. Don't do anything." We've talked about that now for quite a while, right? I mean, it's part of doing business in the Payment Integrity area. But I won't -- I do not believe we've seen a heightened increase in customers putting a pause on things. I think the bottom line is what we do impacts their bottom line. Many of our larger clients are publicly traded entities. You've seen press obviously about some that aren't doing so well. And so the more dollars we can help squeeze for our clients, the better. And now with this new area that we're focused on, we can improve their revenue, their top line. So we really...



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

Yes, I don't think we've seen any macro trends suggesting that there's a pause in activity. I think there's company-specific issues, as Bill said, that we always address. But I think in our view is, the more uncertainty in pressure the health plans are facing, the more our services provide value to them and can actually help offset maybe some other negative impacts they're experiencing.

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**Operator**

And our last question comes from Richard Close of Canaccord Genuity.

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**Richard Collamer Close** - Canaccord Genuity Limited, Research Division - MD and Senior Analyst

I just wanted to get an update. I believe, last quarter, you talked about a pilot program in a certain state where you're working with a managed care organization. You were creating a patient profile. Was there any update that you could give us on that?

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

Well, so they've recently expanded that to have the managed care plans actually use the, what we call, member health profile. And of course, the key issue here is looking at the member from day 1 and being able to see when I see that member, if HMS has seen them before, be able to look at that member and queue up for them the highest risk members so that they can quickly take action. So these management programs, closing gaps in care, noncompliant diabetics, people with multiple chronic conditions, and all of that is queued up in whatever format they'd like to see in the dashboard that we deliver. So right now, the managed care plans are testing the application. This was a very collaborative approach to kind of getting a state that wanted to be at the forefront. We do believe that over time, if we can get both the feds and states to kind of loosen up their view of this, that this will have a significant impact on helping Medicaid managed care plans have an impact on care much faster than the 4 to 6 months that they tell us it takes them to understand a member, so they have for an average of 9 months. So we're still in that alpha mode, but as that product gets through the production testing, we get a minimal viable product out to the market, we'll get more updates on that. But we really do think this is game-changing for the industry, and we think Medicaid needs this more now -- needs it now more than ever.

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

And we do think it actually -- we talked about Essette and Eliza being really entirely commercial focused. We do think there's an opportunity for both of those product lines to be able to sell into the state customer base as well. So having the risk stratification up front and then also being able to provide a member engagement and member management platform, we think, is a comprehensive approach that we think can gain traction in the state market as well, but obviously a much longer sales cycle.

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**Operator**

And at this time, I'd like to turn the call back over for closing remarks.

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

Well, I wanted to just thank everybody for attending our earnings call and your interest in HMS. And I look forward to talking to you again in November. Thanks again.

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**Operator**

Thank you. Ladies and gentlemen, this concludes today's conference. You may now disconnect. Good day.



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