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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the HMS Q2 2018 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to introduce your host for today's conference, Dennis Oakes. You may begin.

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

Thank you, Chi-Chi. Good morning, and welcome to the HMS earnings conference call for the second quarter of 2018. 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 by 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 posted on our IR website.

Bill and Jeff will first provide their perspective on our second quarter results as well as our updated financial outlook for 2018 and then we'll open the line for questions. (Operator Instructions) Before we get started, I want to remind you that some of the statements we will make today are forward-looking, based on our current expectations and a view of our business as we see it today. Such statements, including those related to our full year 2018 financial outlook, future performance and 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 second quarter 2018 Form 10-Q is filed.

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

We're now ready to begin. Bill?

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

Thank you, Dennis, and thanks to everyone listening, for joining our call this morning. Our strong second quarter financial performance is a reflection of our core business model, particularly the leverage we realized as revenue grows, and our intense focus on execution over the past several quarters. Combined with a solid first quarter, we are pleased with what we've accomplished at the halfway mark for 2018.

Jeff will go further into the numbers, but second quarter and year-to-date highlights include: a 10% sequential increase in total revenue, excluding the impacts of the Medicare RAC reserve release in the first quarter; record quarterly commercial health plan revenue, up 16% compared to the second quarter of last year; adjusted EBITDA, up nearly 15% sequentially and more than 30% higher compared to the year ago quarter; and Payment Integrity revenue up over 13% year-to-date compared to the first 6 months of 2017.

Based on our success through the first half of the year, we are raising our full year 2018 revenue guidance to a range of $575 million to $585 million and our adjusted EBITDA guidance to a range of $143 million to $148 million. Both include the positive benefit we received in the first quarter from the Medicare RAC reserve release. We believe these are achievable targets based on our year-to-date performance and the revenue visibility we have for the remainder of the year.

Underlying this across-the-board growth in the second quarter is exciting progress in many aspects of our ongoing efforts to improve both top and bottom line performance. Over the past 18 months, we have made significant investments in technology, revamped implementations and continued our process improvements to increase efficiency and improve product yield, in both our Coordination of Benefits and Payment Integrity products.

In addition to improving our heritage products over the past several quarters, we have also added significant new capabilities through the acquisition of Essette and Eliza and the launch Elli, our internally developed risk intelligence product. This new population management vertical is now available to our large customer base, which is increasingly focused on the consumer, especially, the small percentage of their members who generate the majority of medical costs.

Our care management and consumer engagement solutions accounted for about 10% of total revenue in the second quarter, but grew nearly 35% compared to the prior quarter. We expect strong year-over-year growth through the balance of 2018 and beyond, which will continue to push that percentage of total revenue higher over the next few years.

The Eliza pipeline has expanded considerably since the first of the year and currently includes more than 2 dozen health plans with whom we are having advanced discussions, which could lead to new sales. Importantly, Eliza solutions can also often be implemented and revenue producing in as little as 60 to 90 days. As a result, we are already seeing the benefits from expansion sales to existing Eliza customers and cross-sales to HMS customers, which were made in the fourth quarter of last year and the first quarter of this year. As we demonstrated last fall, when some of our customers asked for a short turnaround in our outreach to members in the path of impending hurricanes, Eliza can quickly organize targeted campaigns when time is of the essence. This quick response capability was evident again in the second quarter as Eliza completed a special project, handling outreach on behalf of a large national pharmacy chain for a drug recall. Which generated revenue of approximately $1.5 million.

Essette, our modular care traffic controller technology platform, provides integrated care and utilization management. New customer wins for Essette are also contributing to growth in our total population management vertical. Most notable is the recent signing of our first Blue Cross Blue Shield logo for Essette with the inking of a multiyear contract with the largest health plan in Puerto Rico. The scope of that work includes utilization and care management solution modules, which will help the plan understand the risk profile of its members and benchmark their network providers.

We launched Elli in the second quarter. It is a risk intelligence application which brings together claims, eligibility, pharmacy, diagnosis, utilization and other data to create rich member profiles. But what is most innovative about Elli, however, is the notion of aggregating data across payers. By doing so, we can analyze the medical profile of new members and enrollment, rather than waiting several months for claims to appear to identify high utilizers or members who need help with the coordinating care. The value of this approach to actionable analytics for our payer customers was quite evident in our pilot project last year. And feedback from others who have seen a demonstration of the technology has been equally positive. Though we do not expect to generate material revenue from Elli this year, HMS is uniquely well positioned to offer this solution for the

Medicaid population because of our large fee-for-service and Medicaid MCO claims database, deep Medicaid expertise and sophisticated clinical analytics and algorithms.

The increased revenue in the second quarter also reflects continued progress on our ink to green initiatives as implementations completed through the first 6 months were ahead of plan, for both COB and Payment Integrity. Since the beginning of the year, the number of projects on hold pending client internal decisions or data issues and delays has declined dramatically. And the inventory of new sales ready for implementation has been reduced by more than 25%. There are now -- there are a number of factors contributing to this progress, but increased upfront engagement with our customers and process improvements, which have led to better overall execution are the 2 biggest factors.

We were confident when the year began that we could rely on our internal innovation capacity. The historically strong demand for our cost containment solutions combined with growing interest in our new product offerings and the support of our dedicated and highly engaged workforce to reach our full year financial objectives. In fact, those assets helped us outperform our original expectations through the first half of the year. As we enter the final months of 2018, we are firmly focused on driving similar success on a full year basis.

Jeff will now share his thoughts on the quarter. Jeff?

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

Thank you, Bill, and good morning, everyone. We are very pleased with our performance in the second quarter from our revenue, earnings and margin perspective. Normalizing for the Medicare RAC reserve release in the first quarter of this year, we grew total revenue over 10% on both a year-over-year and sequential basis. Adjusted EPS of $0.25 per diluted share and adjusted EBITDA of $40 million, were at a significantly faster rate sequentially, again demonstrating the ongoing leverage inherent in our business. Both adjusted EPS and adjusted EBITDA include an add back for the nonrecurring $20 million settlement in the quarter.

Through the first 6 months of 2018, adjusted EBITDA has grown nearly 50% compared to the same period in 2017. Our adjusted EBITDA margin in the quarter at 27.3% grew approximately 250 basis points from last quarter and was up over 400 basis points compared to the year ago quarter.

Technology applications including artificial intelligence, machine learning and natural language processing continued to play a role in revenue improvement and cost containment across our business. The impact of technology is particularly evident in Payment Integrity as more targeted medical record selection, increased volumes and process improvements resulted in better yields and higher PI revenue this quarter.

Expense management remains an ongoing focus, so we were pleased with those second quarter metrics as well. Excluding the nonrecurring $20 million settlement, total operating expenses were down modestly, including a decrease of approximately 200 basis points from the prior quarter and a compensation expense line as a percentage of total revenue. Stock-based compensation declined roughly $5 million as expected compared to the first quarter, which included issuance of our annual equity grants, but that was partially offset by an increase in software amortization of about $2 million.

Turning now to cash generation in the quarter. Cash flow from operations at $9 million, despite payment of the $20 million settlement, was strong compared to $14.7 million in the prior quarter and $17.4 million in the year ago quarter. June 30 cash of $88 million was $4 million higher than the prior quarter-end. We continued to invest in technology, infrastructure and data security to grow our business and to keep pace with changing internal needs and external demands. Capital expenditures in the second quarter were $6.8 million, and we still expect capital spending for the full year will be approximately $33 million.

The effective tax rate in the quarter was 6.7% despite the GAAP operating loss due to discreet tax benefits related to the settlement compared to the negative pretax book income. Excluding the settlement expense, the effective tax rate in the quarter would have been approximately 29.6%. For the full year 2018, we continued and expect an effective tax rate of approximately 28% to 30%, but our current projections suggest it will land at the top end of that range.

Taking into account our results through the first 6 months of the year including both the first quarter Reserve Release, which is included in our GAAP results, and adding back the second quarter settlement spends to adjusted EBITDA, we are raising our full year outlook as Bill mentioned earlier. We have made significant progress over the last few quarters in addressing implementation issues, improving internal processes, enhancing product yields, boosting both employee engagement and customer satisfaction and harnessing the benefits of technology. Combined with the financial results through the first 6 months of 2018, we believe we are well positioned to meet our higher full year objectives.

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

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

Thank you, Jeff. To sum it up, we had a very solid first half for 2018. We intend now to move through the balance of the year with equal determination to continue innovating and executing with consistency and predictability in service to our customers and our members. We do so with confidence in our core assets, an unparalleled combination of data, analytics and customers across the healthcare landscape and a strong belief in the importance of what we do every day to help our customers improve clinical outcomes and reduce healthcare costs. Thank you to all of our HMS associates, customers and shareholders for your support of our mission.

Operator, we are now ready for the first question.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question is from Sean Dodge from Jefferies.

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

Bill, you mentioned expecting strong year-over-year growth out of care management over the coming years. The couple of dozen discussions you're in now with health plans, the big opportunity both in you and existing clients. Can you quantify for us or maybe at least put some bookends around, what your expectations are for growth from that platform over the next few years?

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

Well, we've said that continued double-digit growth and that would be the fastest-growing segment of our business. We haven't really given multiyear guidance on it, but continued double-digit growth. And that's an area of both we're investing in and of course, our customers are reaching out to us for -- because of the need to manage the -- both manage their top line and bottom line, which in this case, we have an opportunity to do so.

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

And this is Jeff. I would just add, Sean, I mean, some estimates are showing member engagement of total addressable market in the $3 billion to $4 billion range and growing roughly 8% a year. We view those as reasonable, so we see the total addressable market as growing and expanding. And so I think the potential to capitalize on that, we see it significant over the next several years.

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

Okay. That's helpful. And then -- so some really nice margin progression in the quarter. Can you parse out for us, how much of that came from the investments you've made in technology? So using the things like AI and machine learning, you talked about that are beginning to pay off. And then I would imagine the runway for investments like that from here is still pretty long. Maybe frame for us how steep of a margin ramp we could see those help drive over the next few years?

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

So this is Bill. I think we have just started to see the payback from those investments. Most of our margin ramp comes from the fact that those investments are helping us provide -- generate additional increased revenue without the additional increased cost. And so as you saw our comp line stayed pretty steady and it's lower as percentage of total revenues. So we think -- we believe that with these technologies continuing to be more broadly used, we'll be able to continue to contain costs, but they're also helping us increase revenue. Jeff?

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

Yes. I think the investments we've made in Big Data are having an impact in our ability to drive our incremental yield. And I think, it's difficult to discreetly break that out, but we certainly track overall yield and have continued to see progress there. And in some of our other investments, things like robotic process automation, natural language processing are helping on the cost side, make us more efficient in how we deliver services and also improve our accuracy. So we do see both the topside and an expense line favorable impact from our technology investment.

Operator

Our next question is from Ryan Daniels from William Blair.

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

I know this isn't a big revenue driver yet but interesting new product with Elli. I'm curious if you can go into a little bit more detail about how prevalent you are allowed to aggregate data across payers? Is that really something that's being approved on a state-by-state basis? Is it kind of national? And then number 2, do you see the early adopters there as state Medicaid plans or more the managed Medicaid organizations?

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

So Ryan, we really started at the state level because the state has the right to take both the claims that are fee-for-service and the encountered claims from the managed care plans and allow HMS to aggregate them. So the importance of that -- now that's just for this one use case, I'll talk about another. But the importance of that is really, that as a member moves through in and out of the Medicaid system in the same state or to different health plans in the state, which they may have -- be forced to do based on geography, the new plan will immediately see the clinical history of the member. And it -- they'll basically understand the clinical profile of their top members that they need to make an interaction with now, day 1, instead of 4 to 6 months down the road when they show up with a very chronic condition in an ER. So we believe that it gives them a couple months to really engage their care management team. And of course, we leave out a lot of false positives. So we think it's going to be most initially adopted in the Medicaid market. Now you've got to remember, we're now selling into a selling season where health plans have to put this in our budget for 2019, which is why we're saying we don't expect a big runway or a big lift in 2018 for revenue. Let me give you just another example. We've had health plans who have to us, just overlaying this data on our own claims is giving us insight we've never had before. So we believe that we have our risk intelligence tool that is geared towards identifying those members that are now chronically ill and may not -- may be underserved from care management or those members that are going to potentially become chronically ill if you do not make an intervention at this point. So the use cases are broader than just the Medicaid market and just sharing data, though sharing data does add significant value.

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

And Ryan, this is Jeff. I would just add, we view it, the risk intelligence component of our total population management offering. So the risk stratification is just the first part, but we can use our Essette and Eliza tools to help manage the care through the care continuum with the Essette platform and actually engage patients to change their behavior to lead to better clinical outcomes. And so we do think, in a comprehensive sense, we have a unique offering. Again, as Bill said, we're targeting our approach to actionable analytics that our health plan and state customers can use to actually improve the quality of care for their members.

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

Okay. And it seems like this is something that could be really high ROI or cost production vehicle for managed Medicaid given the fluidity of those individuals. And I'm curious, if there's an opportunity to leverage your deep long-term relationship with states to kind of them the -- perhaps include this in underwriting for RFPs or RFQs for managed Medicaid business, such that, they have lower cost trends, lower PMPM fees because of this solution kind of pushed the markets towards this type of offering? I know it's a little bit of a unique question, but is there any opportunity for that?

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

Well, there definitely is. I mean we've been talking to states that are either in expansion mode or taking a new population and moving it into managed care or population or state that's going to go to managed care and trying to have them look at this now. But not only use it from an actuarial perspective, but be able to use it day 1 when members enter those plans and they can -- if they require the plans to use the technology, that plan will know immediately what they're getting in risk. So if a whole state is to go -- there's North Carolina will be going from fee-for-service to managed care, I think in 2020, Virginia's expansion starts in 2019, if they were to use those and those new lives went into it, if they've been in Medicaid before, they'd be able to use this immediately to find the appropriate risks that they can take intervention on. And eventually, the state can use it for an actuarial perspective. Basically to say, there may even be plans that are better at diabetes management or better at congestive heart failure or some specific disease that they want to be able to enroll members into.

Operator

Our next question is from Anagha Gupte from Leerink Partners.

Anagha A. Gupte - *Leerink Partners LLC, Research Division - MD, Healthcare Services and Senior Research Analyst*

The first question I had was about the population, the pop health market and you talked about the 8% market growth. How much of your business right now

(technical difficulty)

your existing clients versus in the pipeline, new clients? And is it mostly about the sourcing strategy for the plans and/or the states to kind of reduce the number of suppliers? Or is the suite of services also marketable in -- outside your existing client base?

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

Well, I'll start and then I'll let Jeff answer. So in terms of the marketing, this is being marketed broadly to -- initially to help find market space and providers of services to that market space, whether it be a specialty care management company or even a large independent physician organization that is taking risk. They can use all of the tools, they can use one of the tools. But the Triple Aim approach we've taken has been really to find, to take action and to manage that action with engaging the consumers. So I'd say that in the Eliza, Essette and Elli sales funnel, it's a combination of both sales to existing HMS accounts, which was very critical in the acquisition to show that we could sell to HMS accounts through our relationships. And I believe there's about -- probably about 25 accounts in our sales funnel that we're actively discussing with, that are HMS generated, so the existing HMS accounts is buying our COB or Payment Integrity services. And then the rest are new logos to the company. So we have a very strong sales funnel that continues to build in our TPM solution, and we just started talking to the state market about it, who really have much more arcane tools to deliver these types of services. Jeff, you want to?

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

The only thing I would add from a market sizing perspective, Ana, is the $3 billion to $4 million that I was mentioning was just member engagement alone. If you widen that, it will include total population management, we think its multiple billions of dollars higher. I mean, we have traditionally talked about roughly $180 billion to $200 billion in payment errors in the system. By moving into our total population management solutions, we think that significantly expands the overall total addressable markets to roughly about 1/3 of all our healthcare spending, which the Kaiser Foundation estimates is paid in error, unneeded care. So roughly, the total addressable market goes from $200 billion in errors to almost $1 trillion in errors. So I think -- as we think about what that -- ability to address that with comprehensive solutions that are, again, focused on actual analytics, we like our prospects in tapping into that market opportunity over the next several years.

Anagha A. Gupte - *Leerink Partners LLC, Research Division - MD, Healthcare Services and Senior Research Analyst*

Got it. And then on the payment model that somewhere in the 25% to 30% of the PMPM, is subscription. Can you talk about what the outlook for that would be this year, maybe into '19?

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

Yes, we are seeing -- as we finished 2017, specifically for our Eliza products, we -- I noted about quarter of the revenue was on a recurring subscription model basis. We still view most of the Eliza revenue as recurring in nature. It's just transactional type work that we do every year, particularly as we get into the back half of the year, and we're helping health plans close the gaps in care to improve both our HEDIS and Star ratings. We certainly see moving more into subscription models, so we have seen an uptick in that percentage through the first 6 months of this year. And again, I think it's going to be a process over time. We generally don't expect that we're going to walk in and settle for the subscription model to a new customer, we're going to start with transactional type work and evolve to the project model over time. But I think what we found is, as we run transactions or run -- start running multiple series of transactions for health plans that are volume driven, I think we have a good opportunity transitioning them to the subscription model, where we can also help them target the members that we're outreaching to. And so I think we are getting traction there in that comprehensive subscription model approach and that's certainly the direction we want to drive over the next several years.

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

And while Essette is smaller than that proportionately, it is sold in the PMPM basis a SaaS subscription model. There may be implementation fees and consulting fees. And if a client really requires a perpetual license fee, we'll do it on that type of implementation. And then Elli is primarily for the managed care market, a PMPM or PMPY.

Anagha A. Gupte - *Leerink Partners LLC, Research Division - MD, Healthcare Services and Senior Research Analyst*

Got it. Okay. That's very helpful. Just one more on Payment Integrity, you've grown nicely, 10% revenue growth. How do you think about the growth profile of this business? You've been investing in AI and machine learning, and so the throughput of your claims is -- even with throughput and the same savings rate, you could get in a pretty strong growth profile. How does that play against any kind of competitive intensity in the market as well as customer demand and any pricing changes maybe from your competitors?

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

Yes. I think, Ana, what we've said and others have said, the total addressable market from actual revenue realization stand for Payment Integrity is in the $4 billion to $5 billion range. And as we think about the marketplace for what we know, both public and private competitors, we think roughly $1.2 billion to $1.5 billion of that is currently being met, so we still see a significant amount of whitespace opportunity on the Payment Integrity landscape. And really, as Bill mentioned earlier, we're just starting to see some of the benefits from our technology investments and getting better in how we do Payment Integrity. And so I think, the better you do performance wise, the more business we tend to get from our customers, so I think that's a good trend. We expected Payment Integrity to be a double-digit grower this year. We certainly see that as continuing and see a lot of opportunity and really no change in the demand side from our customers for Payment Integrity, and we still expect our state RAC business, which we've have put under Payment Integrity to be growing as well.

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

Yes. I would see the push from CMS on Medicaid payment program integrity in general, are down to the states and down to the plans is going to be one of the drivers to help grow on the Medicaid Managed Care and the state side.

Operator

Our next question is from Mohan Naidu from Oppenheimer.

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

Bill, one more on Elli. Is this already with the sales force and targeted for this selling season? And since it is a new offering, how should be think about the implementation cycles once you get it (inaudible)?

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

Well, so what's very interesting about Elli is -- well first of all, this is the sales team. We started with a very narrow sales team because it is a new analytics services tool that we felt we wanted to be very targeted at, and we chose some specific markets. But as we've gone out to the market and instead of just looking at aggregating data on the Medicaid side, we found that health plans themselves need this tool regardless of whether it's aggregated or not, either for the opioid analytics part of our tool or for really identifying members, that they really didn't know about, that they could have an impact on now. So the implementation is, it's at state level, we already have all of the data from the state and the MCOs or from the states repository of the MCOs encounters. That's enough for us to implement and really it's just porting it into the Elli tool, which is not a heavy lift. Once we are complete through our entire conversion to our Big Data lake, it will be very easy lift. Now there's a little bit of customization but not much because we're trying to keep this a singular instance of this product and then clients will pay us for additional modules or lenses, we call them, into their population.

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

Got it. And any color on the revenue model that you're targeting here?

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

Yes. So for the states, just because of how states buy, it may end up being more fixed fee solutions. And the managed care plans, it's definitely going to be PMPM or PMPY. Typically PMPY.

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

Okay. Jeff, one quick one for you. Am I understanding your comments right? Are you saying that commercial, without the care management and care -- consumer engagement, you're still looking it as a double digit there?

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

Yes. I think that's the way to think about it, Mohan.

Operator

Our next question is from Richard Close from Canaccord Genuity.

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

With respect to -- just to follow up to Mohan's last question, I think if you pull out Essette and Eliza from the commercial revenue, it was like 6.8% growth in the second quarter. That's down a little bit from the first quarter, which was, I think, around 11%. So was there anything in the quarter sequentially that may be muted the commercial growth? And do you -- you, obviously, now said you're expecting double-digit growth for the year, so just curious, what was happening in the second quarter there on commercial?

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

Well, I mean, we have done a lot of work to position Eliza in Eliza growth. And so -- I mean, as we said, double-digit growth for the year for commercial. So nothing specifically has happened, Richard, in terms of commercial. I think we're -- we still have a very active and successful sales pipeline, and we're still implementing and integrating that. So I think overall, we see good growth opportunities in commercial and expect that trend to continue that we saw in the first half of the year.

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

Okay. And then with respect to the pipeline commentary, Bill, I appreciate that with -- on Eliza. What are the size of the contracts? And when we think of you're -- in discussions with 2 dozen health plans, something along those lines, what's -- what are you seeing in terms of the average size of these potential contracts?

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

Well, there's -- it typically starts out small. Now when I say small, it's a brand-new engagement for Eliza. They'll typically give us 1 or 2 programs. Remember, the programs for Eliza are both to anything from gathering social determinants of health and helping our clients figure out how to use them to draw a specific care management or engagement, all the way to very specific disease-management programs, whether it's medication adherence, whether it's assuring that a certain population gets their mammograms and to drive HEDIS scores or Star ratings. So there is usually going to be some transactional start-up work. It could be low 6 figures and then it grows as we see success. So typically, a lot of the sales activity happens in the second part of the year, when they're looking at closing gaps in care, looking at scores that could be improved, that will improve their revenue through 2019 or impact 2020's HEDIS scores and Star ratings. So there's a sale season that's very active now through the balance of the year.

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

Okay. With respect to the Elli, when do you think you'll have first implementations of that? And just curious on exact timing?

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

Well, I can't give you exact timing because that has to be in the brains of the procurement people at the health plans. But we have proposals in front of, I think, 5 different health plans. Again, typically, analytic -- anything that's additional cost versus contingency fee, gets budgeted around this time of the year for next year. So that's why we're being cautious on -- this may not have an incremental impact until 2020, other than our first state account. It is being bid in other states or presented to other states at multiple levels. Anything from them having this actuarial view across their entire population to a solution for the opioid crisis.

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

Okay. And my final question would be with respect to, I guess, the lower dollar claims, maybe higher margin claims. How are you thinking about that with respect to Payment Integrity and any initiatives along that front?

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

So we have historically been strongest in inpatient institutional claims and probably the strongest across-the-board on the clinical side of that as well as sniff claims. However, we are in the process of building, what we kind of call PI 2.0, where we're going to be doing more prepay on lower dollar claims. So physician outpatient services that we typically have not done as much, though we do data mining on those and pharmacy claims, but we're now going to be moving that into our next version of our prepay products.

Operator

Our next question is from Jamie Stockton from Wells Fargo.

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

I guess, maybe if we take a step back in some of the salutes to Sean's questions earlier and look at just the margin profile of the business. I think if I go way back before you guys bought HDI, the operating margin kind of topped out around 27% on an adjusted basis. This quarter, obviously, very good quarter, you were around 23%. How should we think about your approach to driving margin going forward versus continuing to put the foot down on the pedal from an investment standpoint. I mean have we basically crested the investment period and now we're going to go through kind of a somewhat virtuous margin expansion cycle? If you could just give some thoughts around that, that would be great.

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

Well, firstly, let me give you a little bit of color on that peak margin back in that period. That was when we were primarily COB only, and we were driving sales into managed care plans at a rapid basis. Remember, we went from 0 managed care plans to 90% of the Medicaid Managed Care plans in the nation in 5 to 6 years. That implementation comes with the 3-year retro look back. So you get a pile on of claims activity and cost avoidance activity, that you don't see repeat itself. So that was huge increases in revenue with not the corresponding increases in cost at the same level. Now that we're a more diversified company, we believe that we'll start to regain, and we've seen it year-to-date, a margin grower. Part of that will be driven by the efficiencies that we're putting in through technology. Part of that will be driven by the ultimate shift to a SaaS based model. But we've not completed what I would consider technology investments and believe we still have more to make. Jeff, would you like to?

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

Yes. I think fundamentally, as we think about the business, incremental dollars that come in from both the COB and Payment Integrity product lines, come in at significantly higher margins than the overall company average, excluding any new investments in technology to drive that further.

So I think, as we think about the business, we have our core infrastructure in place to drive both COB and Payment Integrity revenue and incremental dollars, we can get leverage on. I think we are further expanding that with the investments that we are making in technology, both to drive incremental revenue and become more efficient, as I talked about earlier. I think as you add that with our total population management business moving more to a subscription model, we see all those drivers actually helping improve margins over time. We haven't given multi-year guidance on margins. We originally gave a 50 basis point improvement in operating income margin for the year. We increased the guidance this quarter from 50 to 75 basis points. So I think, all the things we're doing, we are focused on driving incremental revenue, but we're equally focused on extracting margin from that revenue. So I think we said the investments we've made in technology are really -- we're in the early innings of capturing that benefit. So I think as we drive revenue growth -- organic revenue growth, we'll see leverage in margin expansions from that. And as we continue to reap the benefits of our technology investments, we'll see margin expansion in that. Again, not having given multi-year guidance, we still see a long runway to improve the margins over time.

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

Okay. That's great. And then maybe just a short-term one. There was a nice step up in Eliza and Essette, and I did catch the comment about having an engagement during the quarter with a national pharmacy chain where you got paid to help them with a drug recall that sounded like it maybe gave you a little boost there. Can you just help us think about that business and how we should be modeling it over the next couple of quarters? Just because the revenue has kind of been a little lumpy with it?

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

Yes. So we do, do those projects from time to time. They are hard to predict. This one was a larger one. But even if we backed out that $1.5 million, we would've still had over 20% sequentially in year-over-year in Eliza. So we would expect Eliza model to follow really historically the same type of trend that we've seen in HMS, with our first half being lower and stepping up in the second half of the year. And we expect, as plans look to close gaps in care, as they normally do in the third and fourth quarter, we'll see growth -- higher revenues in the second half of the year from Eliza versus first half. Q3 might be flattish for Eliza based upon that onetime project we received. And then we'd expect Q4 to be ramping up higher.

Operator

Our next question is from Matthew Gillmor from Robert Baird.

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

I have 2 sort of bigger picture topics I wanted to ask about. The first one's a little bit of a follow-up. With the new HHS secretary, it seems like the rhetoric around combining waste and healthcare has been a little stronger than its predecessor. Is there anything specific coming out of D.C. that'll move the needle for you all, like additional requirements at the state level? I was also curious if that rhetoric just helps the sales environment in terms of giving payers additional license to step up their efforts?

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

So let me talk a little bit about what we hear from CMS and then we think some of the opportunities are. The -- on the Payment Integrity side, clearly Semone Wagner has announced a 3-pronged approach, an approach to Medicaid Payment Integrity. And we believe that they'll put more color around that over the next several months. There is the RAC program on both Medicare and Medicaid. One of the recommendations was that states revivify their RAC programs. As we've said in the past, some states are -- have a RAC contract that just check the box and others are very assertive. So we believe, with all of the new development of product on the Payment Integrity side internally, that our state Medicaid RAC business should grow from both of those physicians. Both a push down from the federal government as well as the innovations we're bringing. On the Medicare RAC side, unfortunately, until the lawsuit with the AHA is resolved, I doubt we'll see much movement there. Though there is a ground, sort of, support for prepay -- prepaid RAC within Congress. And as you probably would guess, we spent a fair amount of time both with Congress and with

HHS. I think HHS does view us as a trusted advisor. I mean, we're on the trusted third-party healthcare private public partnership to combat fraud, we're the Medicaid experts on that. We have several contracts with CMS. So we spent a fair amount of time with them on this. They are very interested in finding ways that are not as abrasive to providers, but to continue to contain costs. And I think the last comment I'll have is, recently CMS issued report cards and they're really quality score report cards for the Medicaid and CHIP programs by state. There is about 90 different factors, most of which are HEDIS or Star rating type factors, the kind of scores that health plans monitor. They did not say what they were going to do with the report cards. But you could imagine an environment where the better your scores, the higher your reimbursement, the lower your scores, the lower your reimbursement in federal dollars as a way to diverge from either just a FMAP as it stands today or moving in a direction where they're really paying for quality. And we think because Eliza impacts all of those course, we have programs around them, that it's an entrée into the states to focus on that. So we think there is a push from the federal government. We think we'll continue to see a push. I think the program that we've not seen as much of a push from is Medicare RAC, and I believe it's related to solving the AHA lawsuit at this point. Jeff?

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

And then just specifically, I would say with that recent legislation that was passed regarding CHIP and our ability to do COB work definitively for the CHIP population that represents an incremental opportunity for us as well as we move into the back half of '18 and into 2019.

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

Okay. That's helpful. And one other I wanted to ask was just around blockchain. I don't think I'd heard you all speak about it before and I think you probably had a little bit more of a buzz earlier this year coming out of HIMSS. But I was just curious, what your thoughts are in terms of how that could be applied or whether it's relevant to your business?

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

So we think -- everybody talks about blockchain, so that's really still in its infancy in healthcare. The industry is in the experimental phase. Gartner projects this phase will last through 2021, probably followed by 5-year period where there'll be -- might be of larger focused investment. Now we are exploring how we might take advantage of blockchain at HMS. We have a new CTO who has experience in that, Jacob Sims. He's been leading large healthcare -- large-scale healthcare IT change and technology-based product development. So we believe there's a position for HMS in blockchain, we just haven't decided in which individual component there is within the healthcare landscape that we will use blockchain. We have been talking to providers of supporting technology, every -- from really all of the largest technology companies you could think of, that are offering a blockchain solution and have been doing design sprints with them. But we have not landed on a product at this point.

Operator

Our next question is from Stephanie Demko from Citi.

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

Just thinking about the revenue and margin ramp for your new TPM client as compared to your core business, how should we think about the initial install cost, the margin ramp and the timing? And how this could maybe impact lumpiness in your revenue model?

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

Stephanie, was it TPM...

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

TPM.

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

You said?

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

TPM. Yes for TPM.

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

Yes. I think as we have viewed it again with Eliza coming on and Essette overall we've said, their margins are comparable to the company's legacy margins. I think one of the things that we are encouraged about is our ability to ramp and convert sales quickly in Eliza -- on Eliza product suite. So we've made the significant investments in technology there and its operating in the cloud. And so I think -- we can convert sales to revenue fairly quickly, in 60 to 90 days or less or even 30 days as we had -- saw in the second quarter, with the drug recall, we did for a large national pharmacy chain. So I think, we've made the investments, already. We don't see a lot of incremental resources needed other than just incremental implementation staff and some production staff to put new customers into production. So I dont think there's a lot of additional upfront costs for total population management on the Eliza side. A little bit more on the Elli side, since it's a new product, but I would expect the revenue to flow and see margin improvement over time in this product suite and no big spikes.

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

Then just thinking about how that's smoothing and you are doing these tech investments, you've had a shift to this PMPM model for TPM, all these things kind of point to a healthier margin going forward. So with that in mind, what is limiting your guidance to 50 to 75 bps of margin expansion?

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

Well I think, look, we said we were measured -- took a measured approach and we gave guidance in February and I think we are continuing to make -- to take a measured approach. I think we had a very solid first half of the year. We believe we are well positioned to achieve the second half of the year. But again, we want to maintain the measured approach in our guidance, but -- so we're well positioned to achieve our targets.

Operator

And the last question comes from Frank Sparacino from First Analysis.

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

I'll just keep it to one. Bill, maybe just a comment on macro level. You have one private competitor, very large, that's been aggressive on the M&A side. Obviously, Cotiviti is merging with another sizable company. I'm just curious what your sort of stance is on that, in terms of potential impact HMS and whether or not you feel more pressure in terms of being more aggressive perhaps on the Payment Integrity side of things with respect to M&A?

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

Well, I mean, I think we're about as aggressive as we can be in terms of making sure we're not overpaying for a particular company. There are not a lot of smaller acquirable entities at this point in Payment Integrity that we find some now and then. And we're very focused on solutions to test in to our TPM suite, which still will not be a --an advanced product line that's emerged Verscend and Cotiviti will have. I think we see it as an opportunity, right now. I mean, we believe we're lower-priced in the market today, that's supported by some facts. So I don't know how quickly they're going to be able to integrate those 2 companies and our clients still come to us for more services all the time, so the demand for PI has not shrunk. And we're continuing to get better at delivering on that product line. So I don't really see that -- I see that more as opportunity than risk at this point. Of course, we're still opportunistic about looking at acquisitions that could be small to transformational, depending on the right deal.

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

Yes. I think we're focused on improving our overall PI results because that's going to be a big driver, we believe, of future expansion in our PI business. And I think we are also just focused on continuing to enhance our overall products suite, so we maintain a position of being a must have vendor that can provide Coordination of Benefits, Payment Integrity and now total population management. As we -- as consolidation continues on the customer side and on the provider side, we think we're offering a comprehensive suite of solutions that are adding real value to our customers. So as Bill said, we're focused on driving our performance in our core business and still looking at acquisitional opportunities that can supplement that. And as we look back on both Essette and Eliza acquisitions coupled with our Elli product, we've really created a new vertical for ourselves over the last 18 months to 2 years, that we think has very good growth prospects.

Operator

Thank you. At this time I'm showing no further questions. I would like to turn the call back over to Mr. Lucia for closing remarks.

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

Well, I want to thank everybody for your continued support of HMS, and we look forward to speaking to you on our third quarter call. Have a good day, everyone.

Operator

Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program. You may now disconnect.
