IOI ChartBook – Express Scripts (ESRX)

Look elsewhere for bullish or bearish investment opportunities

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Three Things You Should Know About Express Scripts

- **Express Scripts succeeded in building the strongest business for the last decade – it may not be the right business for the next decade.**

  The firm spent years making a series of acquisitions that transformed it from a middling drugstore chain to a powerhouse in prescription management. However, the Prescription Benefits Management (PBM) business is shifting, thanks to changes in Big Pharma related to drug development and pricing, changes in insurance related to the introduction of the ACA, and a general trend to re-integrate the prescription management function into insurance firms or firms with a retail presence. Express Scripts worked very hard to build the strongest business among its contemporaries in the aughts, but did not or could not anticipate the changes that look to be making its stand-alone PBM model less relevant in the future.

  Because its standalone business is strong, competitive and has such scale, it is possible that Express Scripts will be an acquisition target. We think the most likely buyer is the Walgreens Boots Alliance (WBA), but realize that Walgreens is more likely to spend some time digesting Boots before making another large acquisition. Time may be on Walgreens' side.

- **The Anthem suit probably has longer-term implications and signals fundamental changes in the PBM business.**

  Anthem (ANTM) is Express Scripts' largest client, making up around 16% of 2015 revenues. It has filed suit against Express Scripts alleging that the PBM has nefariously cheated it by not passing along kickbacks from Big Pharma firms that are a feature of Americas messed up medical system. We think that Anthem will cease to be an Express Scripts client at or before 2019, but that the suit creates two problems that are more serious. First, the suit has raised doubt in other clients' minds that Express Scripts may not be a fair dealer. Second, the suit suggests that the PBM industry is changing and re-integrating with other insurance or drug providers. If customers start to defect and see an integrated model as being more beneficial to their own interests, Express Scripts' valuation is in danger.

- **The stock is fairly valued now, but the potential for both a downward and upward step-change in fair value is very real.**

  Our fair valuation range is almost perfectly reflected in the stock price range implied by the option market. That said, if customers begin to defect *en masse*, we would have to downwardly reassess the forecasts for our preferred profitability measure – Owners Cash Profits (OCP) – for Express Scripts. Doing so creates a fair value range whose average is 30% lower than today's price. On the other hand, the fact that Express Scripts' business may be attractive to a large acquirer (ESRX market cap is $48 billion, so would be a big bite to swallow), suggests that there is upside risk to a bearish investor. We are steering clear of this company as a single-name investment due to this uncertainty, which we believe is too hard to accurately handicap.

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Valuation Overview

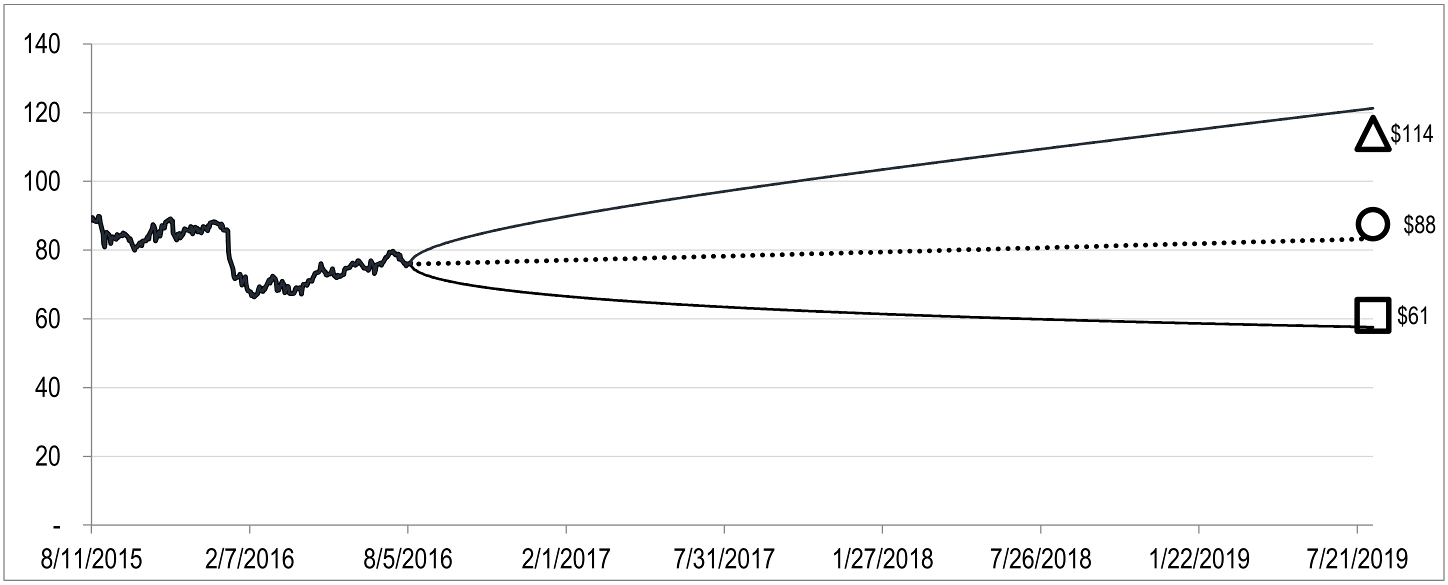

Figure 1. Source: YCharts, CBOE, IOI Analysis. Geometrical markers show IOI's best-case (triangle), worst-case (square), and equally-weighted average value (circle). Cone-shaped region indicates option market's projection of Express Scripts' future stock price.

	IOI Best Case	IOI Worst Case	Historical Median
Year 1-5 Average Revenue Growth	5%	-1%	3%, 11% (5-, 10-year)
Year 1-5 Average Profitability	5%	4%	4% (5-, 10-year)
Year 6-10 Cash Flow Growth	5%	1%	15%

Express Scripts built a dominant position in the world of pharmacy benefits managers (PBM) through acquisitions and by offering insurance companies and company health plans a service that succeeded in holding down prescription drug pricing. It's acquisition of Medco (2012) gave it the leading share of the market and it is the largest pure-play PBM in existence. Recently, trends in drug development and pricing and in insurers' businesses due to the Affordable Care Act (ACA) are prompting insurers to move PBM functions in house. We are concerned that Express Scripts have built the dominant business for the trailing decade rather than for the next one.

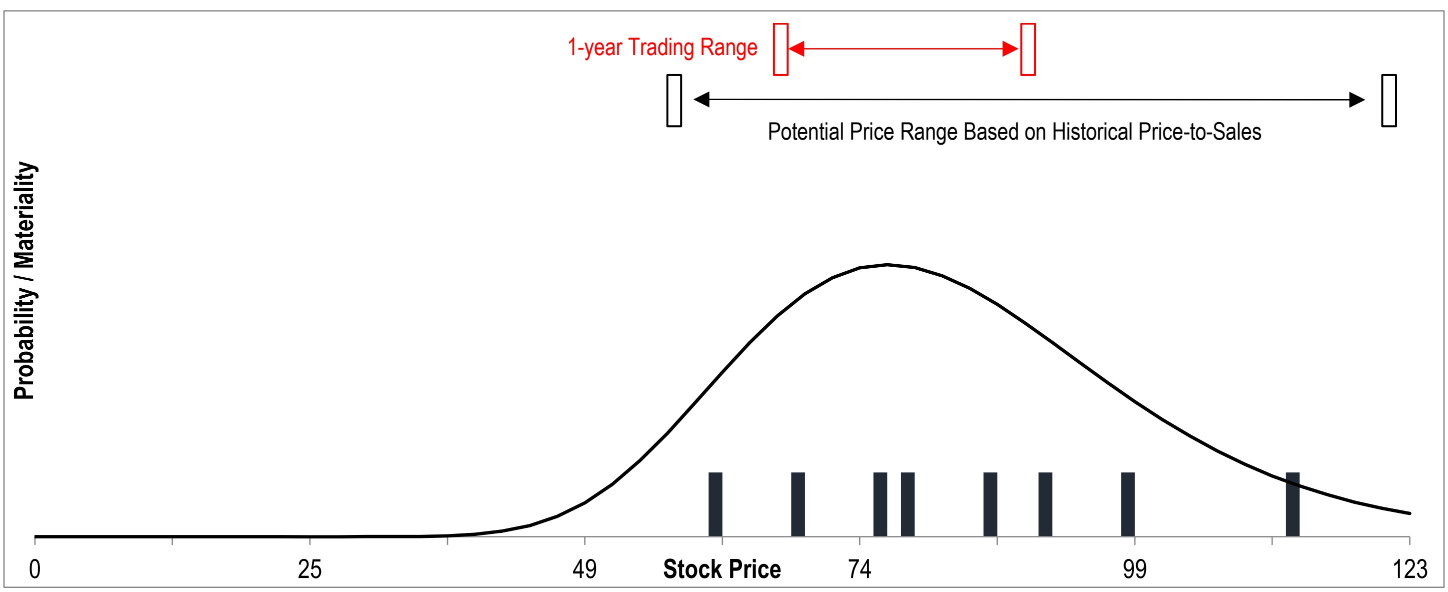

Figure 2. Source: CBOE, IOI Analysis. Curve represents the stock price probability distribution implied by the option market. Blue columns represent IOI's valuation scenarios.

Both the simple valuation range (figure 1) and the complex range (figure 2) tell the same story – this stock fairly valued. Potential investors should look elsewhere; present investors should consider trimming as we see a real possibility for the worst-case valuation scenarios.

Valuation Drivers

Revenue Growth

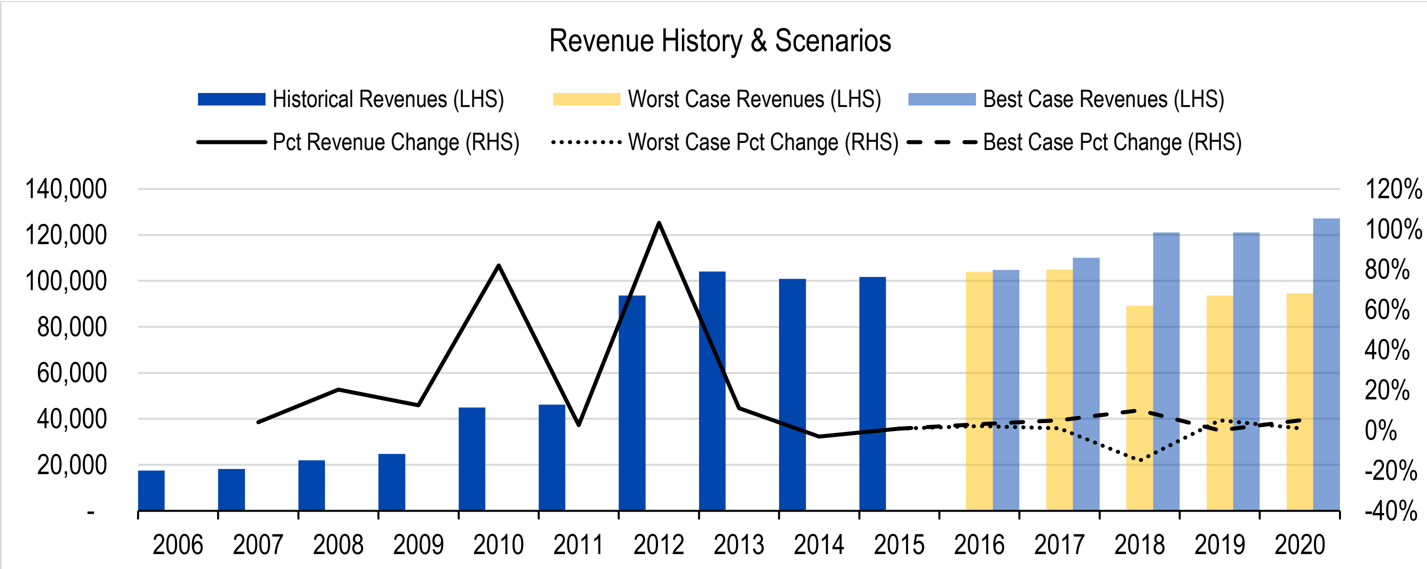

Figure 3. Source: Company Statements, IOI Analysis

The results of Express Scripts' 2010 WellPoint deal and 2012 Medco acquisition on Express Scripts are readily apparent in the chart above. The acquisition of WellPoint's NextRx PBM business made Express Scripts the second largest PBM by market share (behind Medco); the combination of Medco and Express Scripts two years later gave the new company market leading scale. The PBM business is now essentially split into three models:

- Stand-alone: Express Scripts (#1 PBM market share)
- Retail-partnered: CVS Caremark (#2 PBM market share), Wal-Mart
- Insurance-owned: UnitedHealth (#3 PBM market share), Cigna

Express Scripts has a lot to say about how great it is for clients (including insurers) to use a stand-alone PBM, but this rhetoric is becoming tired, especially as the details of a lawsuit filed in 2015 by Anthem against Express Scripts have become public.

Part of Express Scripts' revenues include rebates from pharmaceutical makers that are part and parcel of the ridiculous, overly complex bastardization of the concept of "free market" that we call the U.S. system of medical care. Anthem is suing Express Scripts because the latter failed to pass through some of the kickbacks received from drug makers. Anthem may have ulterior motives for filing this suit since it is attempting to merge with Cigna, which has its own, in-house PBM service. If Anthem could break its contract with Express Scripts (set to expire in 2019) and use Cigna's in-house PBM, it could probably save some money.

The Anthem suit, whatever the real reason for its filing, shows Express Scripts in a bad light and at cross purposes with the medical plans and insurance companies it serves. Considering the vitriol between Express Scripts and Anthem at present, industry analysts have said they expect the relationship to break up whether or not Anthem is successful in its bid to merge with Cigna (the merger is presently in the courts due to anti-competitiveness concerns).

We have represented the loss of Anthem's business in the worst-case revenue case above (dip in 2018). Our original 2015 valuation also presumed a worst-case revenue drop from to a client defection, but it also presumed that Express Scripts would be able to win back that revenue by stealing some other PBM's client.1 We think the Anthem suit may mark the beginning of the end of the stand-alone PBM model, in which case, a major customer defection away from Express Scripts could not be easily backfilled.

Considering the changes to the operating environment and industry trends that seem to favor integrated PBMs, we think it is likely that Express Scripts' management is anxious to be acquired. The best candidate for a purchaser is, we think, the Walgreens Boots Alliance, whose management may be interested in building a business that will be more similar to that of the second largest drug retailer, CVS Caremark. Walgreens made a large acquisition by buying Boots, so another acquisition in the very near future may be difficult and may be delayed by several years. This delay could work out in Walgreens Boots favor if Express Scripts ends up losing customers due to the Anthem fall-out, and its stock price falls.

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[1] Please contact us for a copy of the original report.

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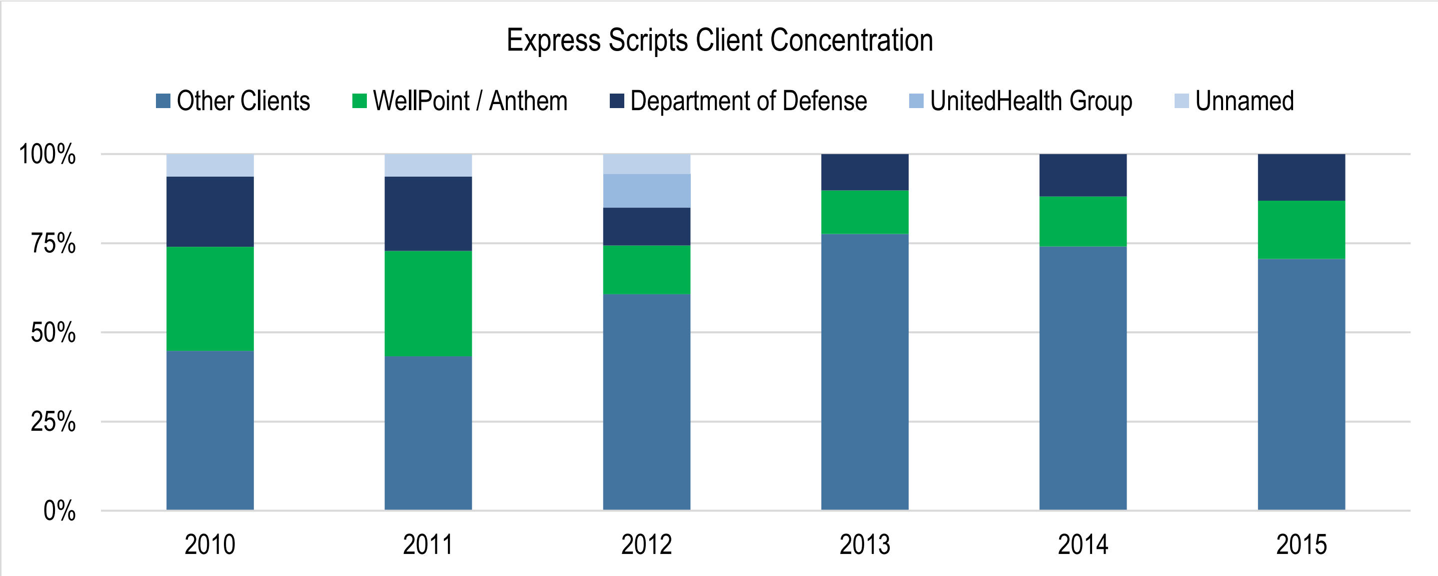

Figure 4. Source: Company Statements, IOI Analysis

The 2012 Medco acquisition reduced Express Scripts' sales concentration, but Anthem business, combined with U.S. Department of Defense business still makes up a large proportion – between a quarter and a third – of the firm's revenues.

It is worth noting how complex the interconnections between clients, providers, and competitors in this business. For example, UnitedHealth, which had become an Express Scripts client in 2001, defected in 2013 and promptly began running its own PBM. This year, UnitedHealth bought Catamaran, a smaller stand-alone PBM, and with this acquisition has developed enough scale to challenge Express Scripts and CVS Caremark. Another example is Anthem, presently Express Scripts' largest client, but became so only after its predecessor, WellPoint, had sold its PBM business to Express Scripts and signed a 10-year contract with ESRX for PBM services.

Profitability

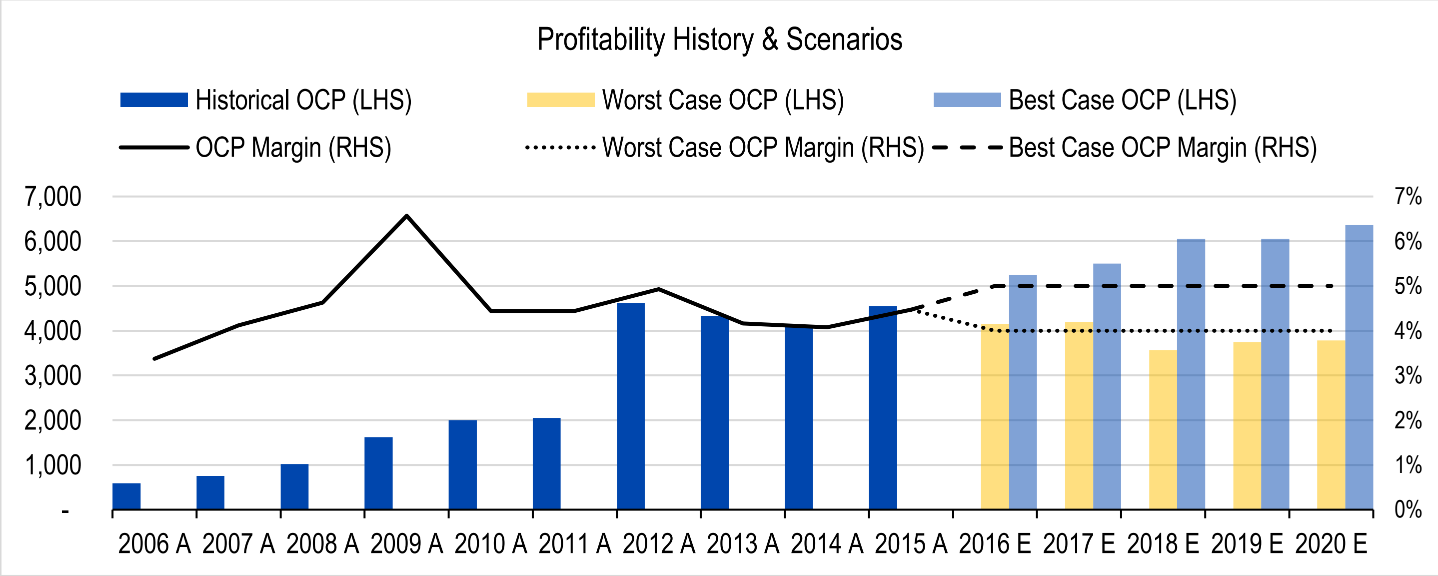

Figure 5. Source: Company Statements, IOI Analysis

Express Scripts' management has pointed out that a robust source of its profits over the last few years has been its business of steering drug consumers towards generic drugs and providing these drugs via online bulk pharmacies. This ability to steer consumers toward generics is contingent on there not being a lot of new, patent-protected being prescribed. Over the past decade, the new drug pipeline has been fairly weak, which has led to a pronounced shift toward generics – a situation that allowed Express Scripts to profit. That pipeline is beginning to fill up, so it will be harder for Express Scripts to generate profits from the generics business.

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There is one important note related to our measurement of Express Scripts' profitability and our forecasts of it. IOI's preferred measure of profitability, Owners' Cash Profit (OCP) deducts an estimate of required maintenance capital expenditures from Cash Flow from Operations. Usually, we base our estimate of maintenance capex on depreciation expense but exclude amortization of intangibles. Amortization of intangibles usually represents the lessening in value of an acquired company's client relationships over time. For most companies, this is nonsense. If an acquiree is treating the clients of an acquired division so badly that the customers will jump ship when their contracts are up, the acquiree is doing something seriously wrong.

In the case of Express Scripts and considering the Anthem suit, amortization of intangibles may need to be viewed as a real item of maintenance capex. If we do this, the average profitability over the last five years is closer to 2% than the present 4%. Making an appropriate adjustment to our explicit forecast generates a fair value range significantly below the present one – implying an average valuation of around 30% below the present market price with seven out of eight scenarios showing a capital loss.

We have not made a change to our model since we believe our assessment of profits is appropriate as long as the Anthem suit does not lead to a wave of additional defections or a fundamental change in the way Express Scripts is viewed by clients and prospects.

Investment Level

Expansionary Cash Flow is IOI's measure of investment spending net of asset sales and divestments.

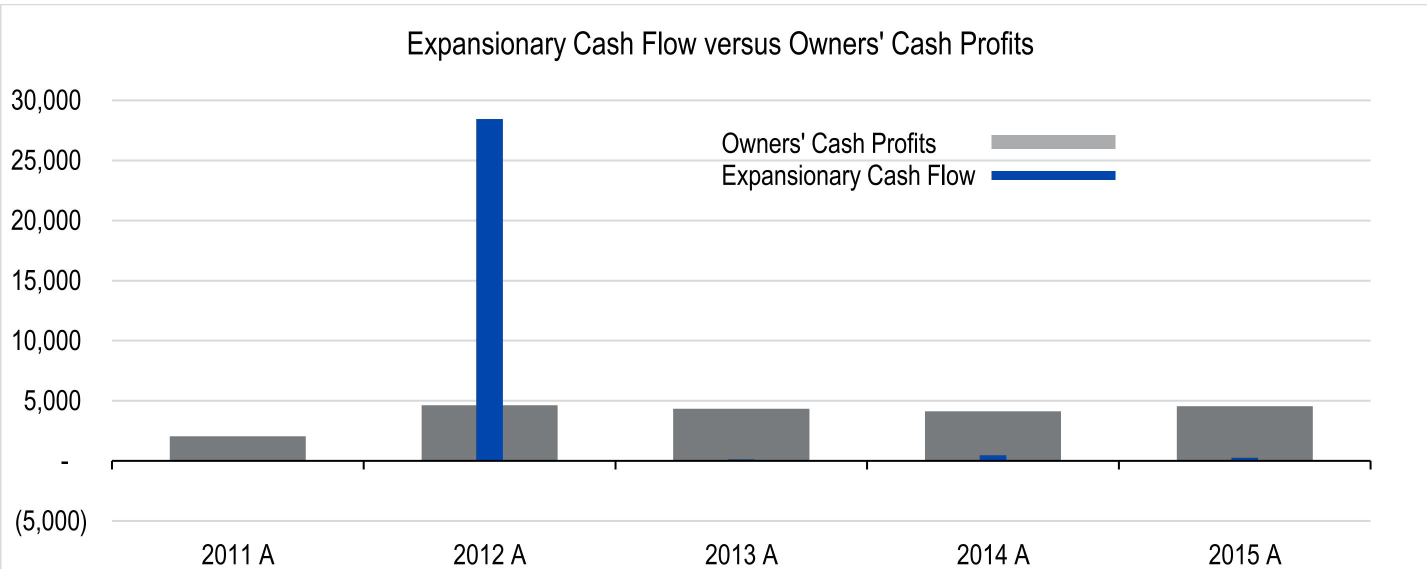


Figure 6. Source: Company Statements, IOI Analysis

Express Scripts' business needs very little in the way of investments other than making the kinds of acquisitions it has already made. There are a few smaller stand-alone PBMs left, but we doubt Express Scripts will acquire these as it already has the scale it needs. The question now is whether its stand-alone business model is appropriate to today's market or if Express Scripts needs a retail or insurance partner to survive.

It's worth noting that the size of the Medco acquisition represents seven years' worth of average post-acquisition profits or twenty-two years of average pre-acquisition profits. It was a phenomenally large investment and likely the last major investment Express Scripts will make.

Most of the money Express Scripts does spend on investments – 7% of profits on average from 2013-2015 – comes in the form of what we term anti-dilutive stock buybacks. We estimate the average expenditures for these anti-dilutive stock buybacks to be $400 million per year over the last three years, but this may go down over the next few years (2015's expenditure was only $200 million).

Investment Efficacy

Corporate investments lead to profit growth. IOI measures profit growth versus the standard yardstick of nominal GDP growth to assess the efficacy of the company's past investments.

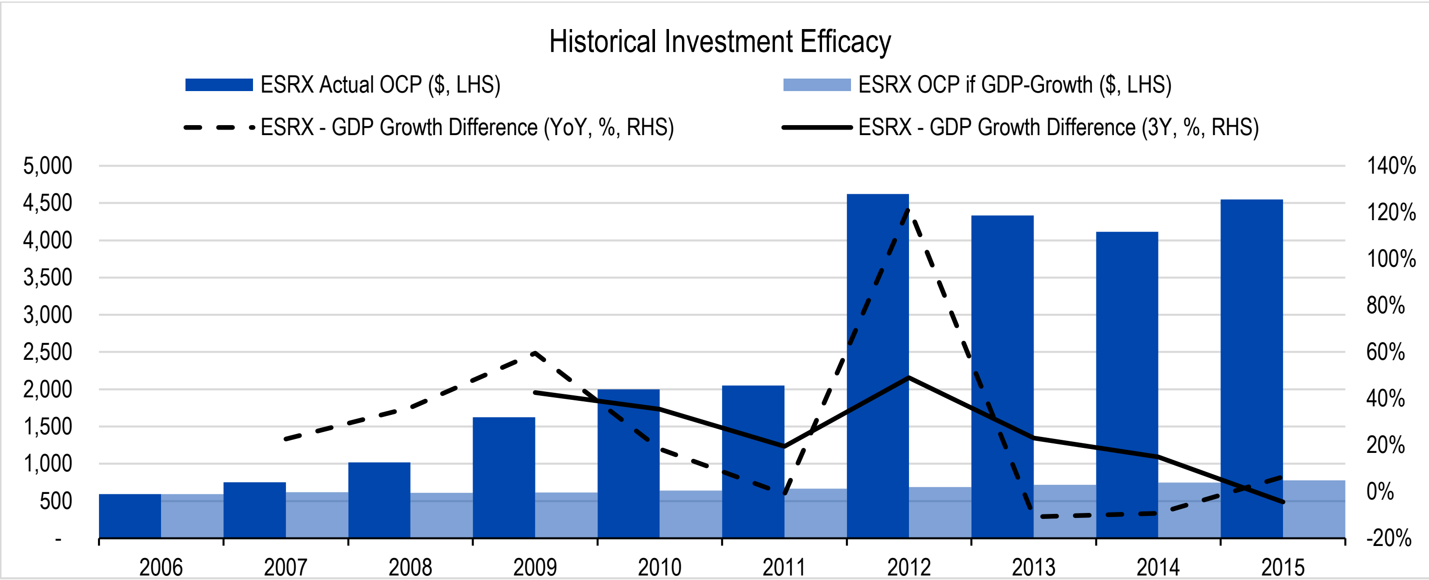


Figure 7. Source: Company Statements, Bureau of Economic Analysis, IOI Analysis

Express Scripts profit growth has been very rapid in comparison to the economy at large, thanks to its acquisitive strategy. Acquisition-led growth is not possible at this stage of maturity in the industry, so we expect much slower growth in future years. Our worst-case estimate is for medium-term cash flow growth of 1% per year and best-case of 5% per year.

Free Cash Flow to Owners

Free Cash Flow to Owners (FCFO) is the metric IOI uses to value companies. It equals Owners' Cash Profits less Net Expansionary Cash Flow.

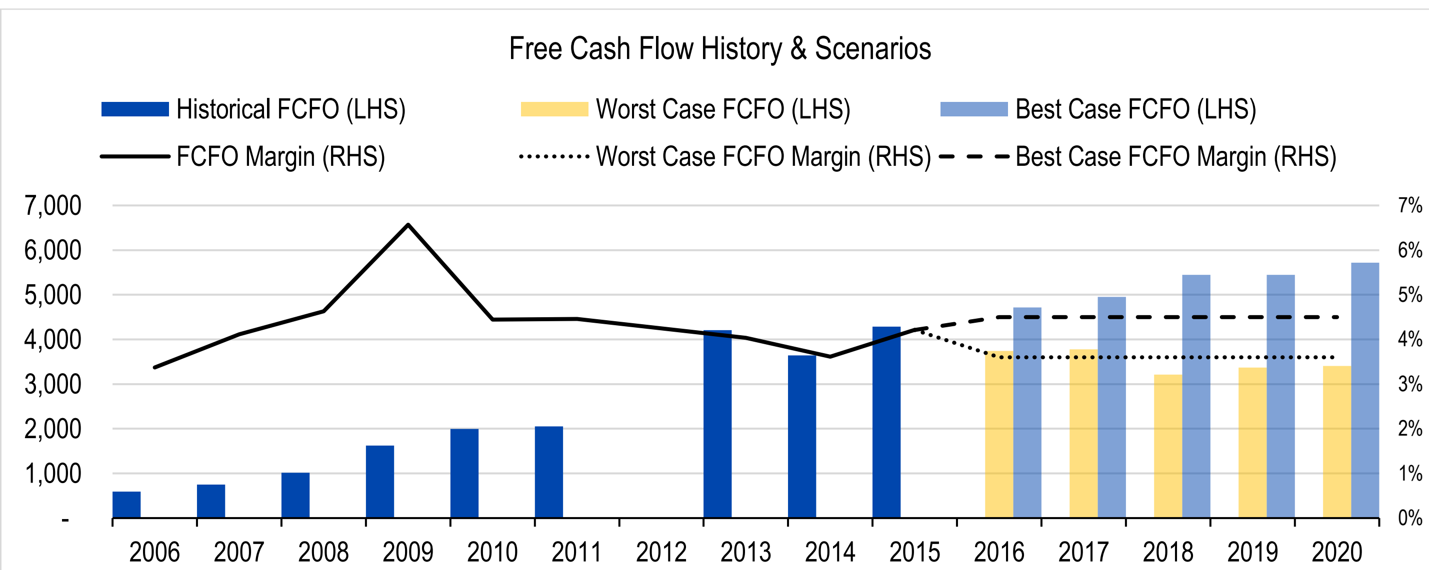


Figure 8. Source: Company Statements, IOI Analysis

Assuming the firm spends 10% of its profits on investments over the next five years implies that the firm will generate Free Cash Flow to Owners of from $0.035 to $0.045 for every dollar of revenues.

Valuation Waterfall

Revenue Growth

The PBM business is mature, highly concentrated among a few large players, and zero sum – one player's loss is another's gain. Our worst-case assumes Anthem either cancels or does not renew its contract and ESRX cannot steal a client from another competitor. Best-case assumes ESRX wins some business and is able to backfill a presumed Anthem loss.

Profitability

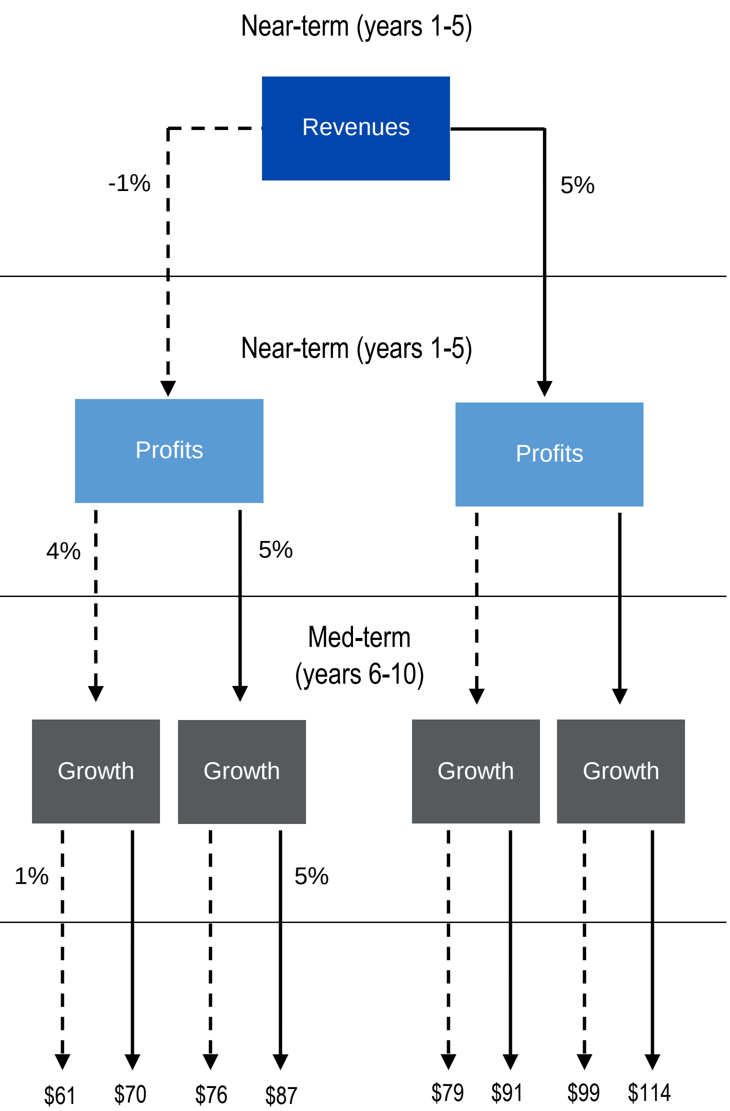
ESRX's profitability profile is pretty stable, so our best- and worst-case profit margin range is pretty tight. That said, we realize that our method of estimating profits may overstate its actual profitability. A simple adjustment to profit margin implies a valuation range much lower than the present stock price.

Medium-Term Cash Flow Growth

The company has expanded its profit much faster than the economy at large thanks to acquisitions. The present environment is mature, so we believe medium-term cash flow growth will be much slower. Our best-case estimate is 5% per year growth; worst-case is only 1% per year.

Fair Value Range

Our fair value range extends from $61 to $114 / share. We are bearish on the firm's prospects from an operational standpoint, but do think the possibility that Express Scripts will be an acquisition target is fairly good. As such, there is market risk to both a bullish or bearish position.



Methodology

IOI analyses focus on three main valuation drivers: revenue growth, profitability, and medium-term cash flow growth. We estimate a best- and worst-case scenario for each of these drivers resulting in a total of 2^3 = 8 fair value scenarios based on discounted cash flow methodology. Profitability is measured by Owners' Cash Profit (OCP) margin. We use a discount rate of 10% for large capitalization stocks.

A wide spread of lowest and highest fair values indicates a firm whose value is uncertain. Risk depends on the stock price's relationship to the valuation range.

Best-case scenarios are represented with a solid line; worst-case scenarios, with a dotted one.

Options involve risk and are not suitable for all investors. For more information, please read the Characteristics and Risks of Standardized Options.

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