ECM | Elgethun Capital Management

Express Scripts (ESRX) - BUY

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Express Scripts (ESRX) is one of the nation's leading full-service pharmacy benefit management "PBM" companies. ESRX has evolved from its early beginnings as a claims processor to a powerful and diverse provider of network and formulary construction, data and drug analysis, and specialty drug and disease management. The company processes 1.3 billion prescriptions per year, has 85 million members, and serves 70,000 pharmacies.[1]

ESRX manages the growth of branded drug spending. While generic drug prices have been trending down over the last 10 years, branded drug prices continue to grow as new innovations are introduced. ESRX negotiates between insurance and pharmaceutical companies to ensure competitive prices. With dominating scale and market share, the company has flexed its muscle against drug companies in the past, leading to substantial consumer savings.

ESRX also provides a valuable and scalable service in managing the data and networks behind the nation's drug volume. For each prescription, significant data is processed to ensure the right co-pay is required, the deductible is set correctly, and any adverse drug interactions are discovered.

ESRX is naturally aligned with the pressures on healthcare and prescription drug spending. ESRX noted that clients who tightly managed their pharmacy benefit held their spending increase to 3.2%, below the nationwide average of 5.2%.[2] The CBO estimated that PBM's could save 30% in drug spending vs. an unmanaged plan.[3]

ESRX has a promising long-term outlook. The growth of chronic and complex diseases provide further evidence that the market will need an advocate to manage and control costs. Given the growth and protected position, ESRX is a high quality, undervalued company. We first purchased ESRX in 2013 in the mid-50's and is one of our largest holdings. ESRX is a core holding for equity investors with a long-term perspective.

Express Scripts		**4/1/2016**
Investment Type		Earnings Power
Industry		Healthcare
Ticker		ESRX
Price		$69.47
Shares		683M
52 Week Range		$65.55-94.61
Market Cap		$43.7B
Net Debt		$12.4B
Enterprise Value		$56.1B
ROIC		14%
	Value	Upside/Downside
Best Case Valuation	$139	98%
Base Case Valuation	$111	59%
Worst Case Valuation	$52	-25%

Thesis/Advantages

- **Leading PBM market share with high barriers to entry**
- **Top three PBMs own 75% of the market**
- **Key advocate to contain rising drug costs**
- **Exceptional growth in specialty pharma**
- **Biosimilar growth provides another way to manage drug costs**
- **Superior leverage over pharma companies and retail pharmacies**
- **Stable and growing cash flow and earnings profile**
- **Significantly undervalued with fair value of $111**

Risks

- **Anthem dispute risks a 5-10% hit to earnings**
- **Insurers are consolidating and building leverage**
- **Growth in generic and mail-order drugs are slowing**
- **Push back on narrow networks and restricted formularies**
- **CEO transition**
- **Opaque contracts between insurers and PBMs**

Segments/Operations

Clinical Solutions
Clinical Solutions provide doctors with benefit and formulary data as prescriptions are written. *RationalMed* evaluates patient health and safety issues involving drugs interactions. *ScreenRx* predicts patients at risk for non-compliance.[4] These services allow real-time patient monitoring, allowing ESRX to predict and correct patient problems before expensive and dangerous interactions occur.

ESRX's National Preferred Formulary covers 26 million Americans and allows ESRX to drive negotiating leverage with drug companies. Other plan sponsors look to this formulary given the work ESRX's Pharmacy and Therapeutics committee has done on evaluating the effectiveness and evidenced-based outcomes of its drugs.

Specialized Pharmacy Care
Therapeutic Resource Centers are the core of Specialized Pharmacy Care. These centers help treat patients with complex, advanced, and costly diseases that require specialized pharmacist interaction. Specialty conditions include cancer, HIV, diabetes, and other complex diseases.

Home Delivery Pharmacy Services
ESRX uses both automated and manual dispensing pharmacies. Mail order services work well for maintenance and long-term therapeutic drugs. ESRX delivers high patient satisfaction, medication adherence, and generic substitution. The consumer enjoys more convenience at a cost below a traditional 30-day supply.

Specialty Pharmacy Services
Specialty drugs treat complex diseases. These medications have specialized administration protocols or involve more rigorous patient monitoring and support. ESRX's subsidiary, Accredo, focuses on injectable, infused, oral, and inhaled drugs that traditional pharmacies cannot support. Accredo has the #2 market position behind CVS/Caremark. Combined, they control over 60% of the market.

Specialty drugs are growing rapidly by both volume and price. According to ESRX, specialty drug spend makes up 37% of dollars spent at 1.5% of total script volume.[6] By 2018, that number will hit 50%. Managing adherence and utilization will be critical. ESRX offers price caps on 60-70% of specialty drugs, providing clients with certainty on worst-case drug spend scenarios. ESRX's goal is to have inflation caps in place for all specialty drugs.[6]

Retail Network Pharmacy Administration
ESRX's manages networks of retail pharmacies, providing negotiated drug prices while delivering volumes of patients to the pharmacy. Pharmacies pay up in order to drive traffic through their stores. With ESRX's large customer base, the company can capture a majority of the value from the networks, another reason why scale is so important in this business.

High Profile Cases Involving Price Negotiations

Turing Pharmaceutical
When Turing Pharmaceutical attempted to raise the price of Daraprim to $750, ESRX worked with Imprimis Pharmaceutical to create a one dollar compounded version.[4]

Abbvie/Gilead
ESRX negotiated with Abbvie to offer exclusive access to Abbvie's drug, Viekira Pak, for Hepatitis C treatment. Gilead's treatments, Solvadi and Harvoni, were dropped from ESRX's national preferred formulary.[5] ESRX gained significant media coverage from the deal, reinforcing PBM's power to constrain price increases.

Walgreens
In late 2011, a dispute between Walgreens and ESRX led to Walgreens leaving ESRX's network for the 2012 plan year. Walgreens pharmacy sales quickly dropped 10% as customers fled to competing pharmacies. Walgreen's management grossly miscalculated customer retention and by some estimates lost 85% of ESRX customers.[8] Less than a year later in June 2012, Walgreens capitulated and rejoined the ESRX network.

Industry

The PBM market is concentrated with the top three companies commanding 75% of the market. ESRX commands 29%, CVS Caremark at 24%, and OptumRx at 22%.[7] This structure is a huge barrier to entry and allows the company to generate an ROIC well above their cost of capital. While market share will shift among the top three, the concentration provides extra incentive to remain rational. The contracts are typically three years and relatively sticky as 90-95% of contracts renew with the current sponsor. Other PBM's include Prime Therapeutics, MedImpact, and Humana's PBM. Outside of acquisitions, the market share within the PBM industry have remained incredibly stable. This result is a powerful indication of the stability and barriers attached to the incumbent players.

Brief Industry Overview

2015	Adjusted Scripts	Revenue	EBIT	EBITDA/Script	ROA	EBIT Margin
ESRX	1,298	$98,960	$4,262	$5.43	8.45%	4.30%
CVS	1,166	$100,362	$3,989	$3.98	7.67%	3.97%
OptumRx	778	$48,272	$1,749	$2.54	6.55%	3.62%

It's difficult to imagine a new entrant recreating ESRX, OptumRx, or the CVS PBM business. The losses and time that would have to be sunk to compete prevent most companies from entering. Given Anthem sold their PBM to ESRX, it would be an abrupt change of pace and strategy for the company to recreate what they sold only seven years ago. With very few natural competitors looking to enter the PBM space, the industry structure should remain stable and support excess returns into the future.

According to Warren Buffet, "Buy into a business that's doing so well an idiot could run it, because sooner or later, one will." While there are very few concerns with current management, there is an incredible margin of safety investing in a business with high barriers to entry in a growing market. In the off-chance that the business is mismanaged, the competitive advantages will allow the company to survive and still create value in the healthcare industry.

One source of industry pressure is the consolidation among health insurance companies. As they gain scale and market share, they will certainly command some concessions as they bid out PBM contracts. Anthem is 16.3% of ESRX's business, with the Department of Defense (Tricare) at 13.1%.

The consolidation across the healthcare supply chain has been staggering. Each industry has seen massive combinations, which should empower rational behavior among the companies. Even though ESRX is seeing consolidation among the health insurers and retail pharmacies, its own market share dominance should allow it to compete aggressively against stronger clients.

A short list of industry consolidation:

PBM Consolidation	Health Insurance Consolidation	Retail Pharmacy Consolidation
OptumRx (UNH) – Catamaran (2015)	Anthem – CIGNA (pending)	Walgreen's – Rite Aid (Pending)
ESRX – Medco (2011)	Aetna – Humana (pending)	CVS - Omnicare (2015)
ESRX – Anthem's PBM (2009)	Centene – Health Net (pending)	CVS - Target's Pharmacies (2015)
	Aetna – Coventry (2013)	

Anthem Dispute

ESRX's biggest client, Anthem, has threatened to pull its contract and move to a competitor unless ESRX can meet its pricing demands. Anthem represents 16% of total revenues, but less as a percent of profit. Given the size of the contract, the Anthem contract is likely at a lower margin and therefore less than 16% of profits are at risk. The details of the contract are not disclosed causing significant uncertainty around the stock. Fortunately, Anthem has very few options to move the business. They would unlikely move the contract to OptumRx, owned by its biggest competitor, UNH. CVS Caremark is the other possible choice. There is no evidence that ESRX is not adequately fulfilling the contract. The contract was competitively bid, so it's unlikely that pricing is unreasonable. My expectation is a mutual agreement is reached, that may involve modest concessions to Anthem. Ultimate resolution will certainly propel the stock higher.

Management

George Paz will retire in May 2016 and will be replaced by company veteran, Tim Wentworth, the current President. George was appointed CEO in 2006 and has successfully built ESRX into the dominant PBM. Although his retirement introduces some succession risk, the structure and stability of the industry and Tim's tenure with the company should allow for a seamless transition. Tim joined ESRX during the Medco acquisition where he served with Medco for 14 years. He also has experience as the CEO of ESRX's Accredo specialty pharmacy.

ESRX is less dependent on exceptional CEO management than most businesses given the structure of the industry. Given its advantageous competitive position, management should focus on widening the economic moat, not diversifying into other businesses or trying to grow outside its core competency. Based on past actions, I'm confident the ESRX team will continue to protect the business in a responsible manner.

Proxy Highlights/Concerns

With any company that exhibits high free cash flow and high barriers to entry, a major concern is how excess shareholder resources are allocated by management.

Long-term incentive awards are a mix of options, restricted stock units, and performance shares, each at a 1/3 weight. Performance shares vest based on total shareholder return compared to industry, EPS growth, and three year average ROIC. The ROIC is a reassuring metric from a shareholder's perspective. Minimum EPS targets are set too low to be binding, which was $1.75 (GAAP) for 2015. 2014 GAAP EPS was $2.64, making it questionable to award a bonus when EPS can fall 30%. Total compensation for top officers appears in-line with the size and success of the business at $3-14 million per year.

ROIC targets range from 10.5% to 11.25%. While most definitions of ROIC have arbitrary exclusions in favor of management, ESRX's definition is relatively clean: [income before extraordinary items / total invested capital]. It's reassuring that the figure is not loaded with exceptions.

The Medco acquisition raised some concerns. The board phased in the acquisition over five years, which reduced the invested capital base and allowed management to hit its targets. Making exceptions for large acquisitions is usually problematic as most large acquisitions don't meet expectations. Given management's history of creating value for shareholders, this exception is a minor issue for investors.

In summary, there are a few minor concerns in the proxy, but nothing outrageous. Almost every public company has issues and faults with compensation structures, and ESRX avoids the major pitfalls.

Capital Structure

ESRX carries $15.6B in long-term debt. The maturities are spread fairly evenly across the next 10 years, with a larger amount of $4.2B coming due in 2017. Given the impressive free cash flow generation, the company has more than adequate cash flow to maintain the current debt level and capital structure. The company has an immaterial pension deficit of $42.4 million. ESRX targets 2x debt to EBITDA levels, but has noted that the target will move around based on opportunities. Current debt to EBITDA is at 2.3x, interest coverage is over 8x, and debt/equity sits at 1x.

ESRX does not pay a dividend, but may be initiated in the next few years as the shrinking pool of candidates leaves fewer acquisition opportunities. The company generates so much cash on a consistent basis that it makes sense to start returning cash outside of share buybacks. ESRX does not need acquisitions to grow from here since its scale and market share will drive growth.

Since the merger with Medco, the company has generated $4.5-4.8B in operating cash flow per year. Given capex spending averages $300-400 million, ESRX easily clears $4B in free cash flow, excluding any acquisition spending. At $68.91 and a $43.7B market cap, the free cash flow yield is over 9%.

The company has continued to buy back shares and it's impressive to see them buying as the shares have fallen to the mid-60's. The company has spent $4B in 2013, $4.5B in 2014, and $5.5B in 2015 on buybacks. Most companies are notorious for buying back shares near peak, only to stop share repurchases when the stock falls and actually becomes attractive and undervalued. Share count has decreased 15% over the past two years.

Threats/Risks

The PBM industry is affected by increasing regulation and government legislation. While some investors may view this list with trepidation given the uncertainty surrounding future legislation, the regulations impose a barrier to entry for small competitors that must understand and adhere to the thousands of requirements across varying regulatory bodies.

An abbreviated list of regulatory programs:

- ERISA – regulate healthcare plan arrangements
- Healthcare Fraud and Abuse – governs payments and referrals with a health benefit program
- Network Access Laws/Any Willing Provider – may limit how ESRX can build and/or limit their pharmacy networks
- Drug Pricing Laws and Most Favored Nation Pricing
- Medicare and Medicaid Reimbursement Regulation
- Medicare Coverage Requirements
- HIPPA – Privacy Laws for Healthcare Information

Valuation/Earnings Power

- Sustainable, long-term earnings power for ESRX is +/- $5.90 per share. Company guidance is a little above at $6.10 to $6.28 for 2016, but I'm less concerned with picking 2016 EPS than about the sustainability around this level. There are always moving parts around contract wins/losses and changes in the healthcare field, but this business is more than capable of growing from this base over a long period of time. Integration costs from the Medco merger have finally disappeared, leading to cleaner financial results.

- A majority of the difference between GAAP earnings and adjusted earnings is the customer contract amortization from the Medco deal. I expense one-third of the amortization and assume two-thirds of the amortization will not need to be reinvested.

- Operating margins have ranged from 3-6%, averaging 4.5% over the past 10 years. While most analysts project increasing margins, even flat margins will drive the stock higher. At 10x free cash flow, investors don't need a lot, if any, growth to see upside.

- Company EBITDA guidance is between $7.2B and $7.4B, valuing the company at 8.3x Enterprise Value to EBITDA.

- ROIC ranges between 12-14%. Given the stability of the industry and consistent free cash flow, ESRX should continue to compound value for shareholders.

- Finally, fair value is $111 under our base case scenario. Under our worst-case, slow growth environment ESRX is worth $52. Under a best case scenario, the stock could hit $139 as drug spending and script growth accelerate.

Valuation Scenarios

	Growth	EBIT Margin	Sustainable Earnings	Value	Price/Value
Best	6%	5.0%	$6.22	$139	.50
Base	4%	4.5%	$5.62	$111	.63
Worst	0%	3.5%	$4.47	$52	1.35

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