

Pharmacy-Benefit Managers Under Pressure

By

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High-priced drugs have everyone ticked off this year. And for good reason. While health-care spending in the U.S. is growing faster than the economy, pharmaceutical costs are growing faster still. New treatments for arthritis and cancer certainly merit a premium, but pharmacy bills can't grow unchecked.



IMAGE: C.J. BURTON FOR BARRON'S

A whole industry exists to keep drug bills in check, of course, namely pharmacy-benefit managers, or PBMs. Leaders like [Express Scripts Holding](#) and the pharmacy-benefit units of [CVS Health](#) and [UnitedHealth Group](#) have rung up big profits in recent years while promising to slow the upward trend in drug prices. But the relentless rise raises questions about their effectiveness.



— ADVERTISEMENT —



There are other reasons for investors to wonder about the prospects for PBMs. After rising four times more than the market in the past decade, shares of Express Scripts (ticker: ESRX) got knocked for a loop early this year when the company's largest commercial client, health-insurer [Anthem](#) (ANTM), claimed in a lawsuit that Express Scripts was overcharging it by \$3 billion a year. Express Scripts disputes the claims, and the stock has begun to recover. But analysts fear that the PBM will lose Anthem's business and, with it, as much as 20% of its earnings.

A broader challenge was the recent launch of the Health Transformation Alliance, a coalition of 30 of the country's biggest employers who want to get more for their health-care dollars. Their roster includes American Express, Caterpillar, Coca-Cola, IBM, Shell Oil, and Verizon Communications (a list of the first 20 to join appears below). As a group, they spend over \$20 billion a year on health benefits.

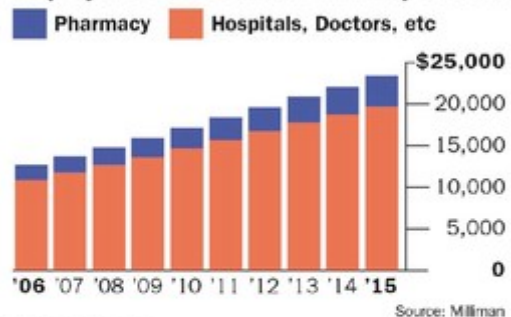
Unhappy with the health-care status quo, the companies set an early goal of making prescriptions more affordable for their six million employees. They'd do this by rewriting their pharmacy-benefit contracts to eliminate the undisclosed drug-price markups that supply much of the PBM industry's profits. Instead, the PBMs would mainly receive administrative fees, which would be significantly lower.

"That's clearly not the business model that the big PBMs have today," notes David Dross, who heads the prescription consulting practice at Marsh & McLennan's Mercer unit. "It would be asking them to step away from the way that they do business."

Health-Care Costs Keep Rising

Companies (listed below) are joining forces to contain insurance costs, led by drug expenses.

Employer's Cost to Insure a Family of Four



HTA Members:

American Express	Ingersoll Rand
American Water	International Paper
BNSF Railway	Lincoln Financial Group
Brunswick	Macy's
Caterpillar	Marriott International
Coca-Cola	NextEra Energy
DuPont	Pitney Bowes
HCA	Shell Oil
Hartford Fin'l Svc Group	Verizon Communications
IBM	Weyerhaeuser

It could take several years to see whether the alliance members can carve the fat from their PBM contracts. Many of these big companies are probably customers of either Express Scripts or CVS (CVS), which dominate this portion of the marketplace. Their margins would be severely affected. Although it would be hurt by any pricing downtrend, UnitedHealth Group (UNH) has less immediate risk in the alliance's actions.

At 79 bucks, Express Scripts shares reflect the Anthem worries. They trade at just 12½ times this year's expected earnings. Should big customers rebel, however, this pure-play PBM could see its earnings and stock price come down substantially. CVS gets about 39% of its operating income from benefit management and a specialty pharmacy, so it, too, could face a big hit, particularly since it trades at a respectable 17-times multiple. UnitedHealth generates just 16% of its operating earnings from its PBM unit, and, therefore, its 18-times multiple would be vulnerable, but less so than the others. Industry leader Express Scripts has grown tenfold since *Barron's* extolled its prospects years ago ("[Rx for Prosperity](#)," Jan. 20, 2003). Those heady days are over.

THE MAJORITY OF AMERICANS, about 170 million, get their health benefits from their employers. Maintaining those benefits hasn't been cheap. As we show in the nearby chart, the annual cost of employer-sponsored health care for an American family of four rose 84%, to almost \$25,000, over the decade ended in 2015, according to the insurance consultants at Milliman. Drug costs are 16% of the total, a smaller piece than either hospitals or doctors. But the cost of drugs has risen faster than any other health-care expense. It's up 102% over the same decade. Last year alone, it spiked 14%.

Big-ticket specialty drugs drove much of last year's burst. The heaviest burdens aren't the obscure, outrageously priced pills that earned notoriety for Turing Pharmaceuticals, under Martin Shkreli, and [Valeant Pharmaceuticals International](#) (VRX), but rather the medications from mainstream drug companies for prevalent diseases like cancer and hepatitis C, which can easily cost \$50,000 for a course of treatment. Many forecasters expect that specialty drugs will account for half of pharmacy bills by 2018.

Human-resources chiefs like those involved with the Health Transformation Alliance worry that health-care inflation will force their companies to roll back benefits. Another concern is the so-called Cadillac tax contained in the Affordable Care Act, or Obamacare. Starting in a few years, it will hit employers with a 40% excise tax on any health plans that spend more than a certain dollar amount.

The End of the Uptrend?

After a great run, shares of pharmacy-benefit managers have begun to level off as criticism rises about their efforts to limit drug-price hikes.



Source: Thomson Reuters

Company/Ticker	Recent Price	Market Value (bil)	Enterprise Value (bil)	2016E EPS	P/E
UnitedHealth Group / UNH	\$143.69	\$136	\$160	\$7.91	18.1
CVS Health / CVS	96.55	104	130	5.82	16.6
Express Scripts Holding / ESRX	78.86	50	65	6.35	12.4

E=Estimate

Sources: Bloomberg

To stem the rise of drug costs, PBMs typically offer a combination of remedies. With the aggregate volume of its health-plan clients, a PBM can negotiate discounts from

drugmakers and drugstores. It steers plan members from brand drugs to generics, and from retail stores to mail order. As a result, the PBM guarantees that a health plan will get a fixed discount off drug manufacturers' list prices. A common example would be 15% off brand prices and 80% off generics.

Each of these tactics is also a source of profit for the PBM. A drugmaker will pay rebates to a PBM that shifts market share to the drugmaker's brands by making rival brands more expensive to plan members, or by excluding rival brands altogether. PBMs get deep discounts on generics from manufacturers who want to supply their mail-order business, and from drugstores that want to become part of a preferred retail network. Yet a PBM doesn't necessarily pass through all of these rebates and discounts to its health-plan clients. The PBM typically won't tell its clients how much of the discounts the PBM is pocketing. This black-box aspect of the industry has long been a source of gripes.

A decade ago, health plans started asking PBMs for more-transparent contracts. The PBMs responded by offering such contracts with a smaller savings guarantee, say, 22% off list price, compared with 25% off for a traditionally opaque contract. Come the 2008 recession, however, most plans were willing to revert to the black-box deal, recalls John J. Malley, the leader of pharmacy-benefit consulting at Aon Hewitt.

These arrangements have served clients well, say PBMs. Express Scripts spokesman Brian Henry says that customers saw their drug spending increase by just 5.2% in 2015, compared with 13.1% in 2014. Health-plan customers that adopted more of his company's solutions—such as restrictions on drug and pharmacy choices—held their spending increase to 3.3%. CVS, for its part, has said that it kept pharmacy spending growth to 5% last year, compared with 11.8% in 2014.

CVS BECAME THE SECOND-LARGEST PLAYER in the PBM business when the drugstore chain acquired Caremark Rx in 2006 for \$21 billion. [The company has gone from strength to strength in recent years](#), growing revenues to \$153 billion in 2015 and earning \$5 billion, or \$4.63 a share, while paying dividends totaling \$1.40 per share. Retail stores accounted for \$72 billion in revenues, and pharmacy-benefit services accounted for \$100 billion (\$19 billion in internal sales was eliminated in the company's total). Caremark's pharmacy for specialty drugs, like injectable treatments that need refrigeration, is the biggest in the business. One popular innovation from CVS enables its retail locations to dispense 90-day prescriptions to benefit-plan members, just like a mail-order service.

Investors have rewarded CVS shares by boosting them by nearly three times the Standard & Poor's 500 index's return in the past five years, to a recent \$97. Figuring the stock has had its run, Morgan Stanley analyst Ricky Goldwasser downgraded CVS to Equal Weight last month, with a 2016 forecast for earnings of \$5.83 per share, and in 2017, \$6.54 a share. Her target price is \$104.

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One thing prompting her downgrade was the heightened industry competition evident in CVS' loss of three big pharmacy-services customers to UnitedHealth's OptumRx unit. The state retirement programs Calpers and Texas ERS, along with General Electric, were big wins for the giant health insurer's PBM, which became a strong No. 3 in the industry last year with its \$13 billion acquisition of Catamaran.

The OptumRx segment of UnitedHealth had 2015 revenue of \$48 billion, but OptumRx can aggressively compete on price with the backing of a parent whose total revenues were \$157 billion, with earnings of \$5.8 billion, or \$6.01 a share. The stock has many fans, including Barclays analyst Joshua Raskin, who has an Overweight rating on the shares, in part due to the company's multipronged approach to health care.

EXPRESS SCRIPTS has remained a pure play on pharmacy-benefit management. It runs a big mail-order operation and has the second-largest specialty-drug pharmacy. Revenue growth flattened out in the past few years, with 2015 sales coming in at \$102 billion. It earned \$2.5 billion last year, or \$3.56 a share. Morgan Stanley's Goldwasser cut her rating to Underweight in June, after concluding that Express Scripts' falling out with Anthem could cost the PBM as much as 25% of the \$7.11 in earnings per share she'd otherwise anticipated for 2018. Her target for the stock, recently \$79, is now \$70.

Like Priceline.com and eBay booking revenue for the stuff others sell on their sites, the PBMs claim the drug sales of retail pharmacies for which the PBMs set the drug's price. Accounting regulators have let PBMs count drugstores' sales on the PBM's income statement, under the rationale that the PBM does more than just pass along the health plan's payments. This accounting treatment also makes a PBM's profit margins appear more modest. That comes in handy when PBMs encounter complaints that they are "over-earning" for their services.

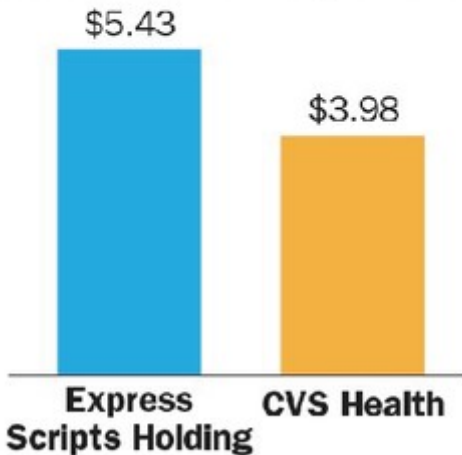
Express Scripts has been dogged by questions about whether it makes too much money at the expense of drugstores, drugmakers, and even its health-plan clients. On each of the 1.3 billion prescription claims it handled in 2015 (adjusting all scripts to 30-day equivalents), Express Scripts averaged earnings before interest, taxes, depreciation, and amortization of \$5.43 apiece, compared with \$3.98 at CVS. Critics argue that Express' industry-leading profitability comes from overcharging clients like Anthem and selling services to drugmakers, which arguably conflicts with its cost-containment mission.

The PBM says its work for the drugmakers ensures patients' access and compliance.

Cash Spinner

Express Scripts' cash flow per prescription exceeds others', drawing scrutiny.

2015 Cash Flow per Rx*



* EBITDA per adj. claim

Source: JPMorgan

The Pharmaceutical Care Management Association, a trade group, argues that drug prices would have risen even higher without its interventions, and it published a study in February predicting that PBM customers would save \$654 billion on drugs in the next decade.

One prominent industry gadfly is Linda Cahn, who brought the first class-action suit against PBMs in 1997. The Morristown, N.J.–based lawyer now advises health-plan sponsors about the pitfalls in PBM contracts. In the hundreds she has reviewed, she says almost all let a PBM decide whether a drug is considered a generic or a brand—thereby changing a 78% discount to a 15% discount. Contracts allow PBMs to relabel rebates, so they needn't be shared with health plans; one PBM had 35 different names for such payments. “Health plans don't realize they are signing contracts that effectively say, ‘Charge me whatever you want,’” says Cahn. “They need to realize they're getting scalped.”

In the March lawsuit that Anthem filed in Manhattan's federal district court, it alleges that Express Scripts is charging Anthem plan members \$3 billion a year in excess of prevailing market prices for drugs under the 10-year contract they signed in 2009. Express Scripts' response, filed in April, disputes that dollar amount while acknowledging that it's charging Anthem above-market prices in a quid pro quo for the

\$4.7 billion it paid Anthem to take over the insurer's struggling PBM unit. Anthem could have gotten a better deal for its members, says Express Scripts spokesman Henry, if it hadn't wanted so much money up front. While the suit drags on, the PBM will continue to service Anthem members. Executives at both companies have told investors that they won't back down.

THE RISING COST OF PHARMACY BENEFITS, with their opaque pricing and hidden spreads, have compelled the companies in the Health Transformation Alliance to pool their resources and seek better deals. One of the HTA's first projects, says Tevi Troy, its executive vice president for public policy, will be a data warehouse allowing members to compare health-care prices and outcomes. Another project would help health plans better control their drug benefits by separating the PBM services of claims administration, mail order, and specialty pharmacy.

"All [the HTA] is recommending is stuff that is already in the marketplace," says Mark Merritt, head of the pharmaceutical care trade group. "But if they can come up with new ways to save money, that's great."

Similarly, CVS says the alliance and its objectives aren't unique. Spokeswoman Christine Cramer says, "We continue to deliver innovative solutions that improve cost, quality, and access for our clients." UnitedHealth declined to comment.

Many previous efforts to tame health-care costs were failures, acknowledges Troy, who was a deputy secretary of Health and Human Services and senior White House aide for George W. Bush. The HTA thinks it can succeed now because data analytics are better and can study million of patients, because it will combine the market power of its big members, and because it doesn't rely on any government action. "We're not trying to lasso the moon," he says. "But we hope to come up with something that works regardless of who wins the 2016 election."

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