

The Express Script – Wellpoint PBM Deal:

A “Double-Trouble” Front

By

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Disclosures:

I have not received any remuneration for this paper nor have I financial interest in any company cited in this working paper.

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Introduction

On April 13th 2009, Express Scripts, the third largest independent pharmacy benefit manager (PBM), acquired the captive PBM business of Wellpoint, one of the largest integrated healthcare insurance companies and the largest Blue Cross Blue Shield (BCBS) licensee in the United States. The deal was for \$4.675 Billion to service the 25 million people, and their 265 million prescriptions.¹

The Wellpoint – Express Scripts deal is not a typical outsourcing of benefits management where there is little risk to the benefits manager that its costs would not be covered by fees or reimbursements. What is different is that this deal involves a full “book of business” – revenues as well as costs – and it includes a substantial share of risky, fixed premium insurance plans. And, while Express Scripts as buyer is in the best position to improve the gross profits of this book of business, Wellpoint as seller is the more efficient manager of sales, general, and administrative (SG&A) costs.

Both parties seem defensive when it comes to specifics. Consider the following exchange during Wellpoint’s 1Q2009 conference call:²

Matt Perry - Wachovia Capital

And if I could just ask a second question on the sale of NextRx..... Just wondering how the deal might be structured in terms of who gets that ultimate savings, does Wellpoint recoup certain amount of savings from [\$1] or is that just split in a certain way from the first dollar just wondering how that might be structured?

(Wellpoint CEO) Angela Braly

Well Matt, we don’t want to get into too great detail about that because obviously that we would lose a competitive advantage if we did.

And consider this exchange during Express Scripts' 2Q2009 conference call:³

Ross Muken – Deutsche Bank

... I mean is there any sort of change to the belief in terms of some of the synergy capture early on versus later in the process or any of the moving parts that comprise where the earlier guidance changed and just, I'm just trying to get a sense of sort of how best to think about what you've learned in this time since the original announcement versus today. In terms of what you're willing to share?

(Express CFO) Jeffrey L. Hall

Yeah. I'm not willing to share very much at this point is the short answer. The longer answer is as I said earlier is the great group of people we've been interacting with. We feel like the, we're building good relationships there. We think it's going to be a great relationship. We like the program. We're positive on all fronts. We think there are lots of good things, but we are just not ready to update guidance at this point. There's not really any point. Once we get the deal closed and have final integration plans, we'll give you an update with a lot more detail.

The purpose of this paper is present a more detailed view of the likely structure of this deal. It is based on quantitative estimates of (1) the proportion of Wellpoint's business represented by fixed premium plans; (2) the premium Express Scripts is paying for this business; and (3) the relative efficiencies of both parties in managing the SG&A costs of the business.

The following diagram is a representation of the types of deals that could have been structured between Wellpoint and Express Scripts. We will present the case that the two parties have chosen to structure the deal as a "double fronting arrangement" because it solves the dilemma of how to capture Express Scripts' strength as a PBM specialist and plan converter while holding on to Wellpoint's status as an insurance underwriter and the more efficient SG&A manager.

The Variety of Deals between WLP- ESRX

	WLP Owns Business	WLP Outsources PBM to Indy Contractor	WLP Sells Business	WLP Sells Business WLP Front	WLP Sells Business WLP Double Front
Revenue - Premiums, Reimbursements Less: Cost of Sale - Provider Payments	WLP WLP	WLP WLP > ESRX	ESRX ESRX	WLP > ESRX ESRX	WLP > ESRX ESRX
Gross Profit Less: SG&A	WLP WLP	WLP WLP	ESRX ESRX	ESRX ESRX	ESRX WLP < ESRX
EBITDA	WLP	WLP	ESRX	ESRX	ESRX

But, the complexity of this arrangement will cause problems for Express Scripts. In the short term, Express Scripts will face regulatory scrutiny concerning its status as a “risk-bearing entity” despite Wellpoint being the nominal underwriter of fixed premium plans. Also, it is likely that Express Scripts will retain Wellpoint as routine manager of SG&A and this arrangement will cause ongoing and long term tension between the two parties over who is managing what and how.

The Variety of PBM Business Models

Express Scripts’ current business of servicing self-insured plans is completely different from Wellpoint’s business of managing a mix of fixed premium and administrative services only (ASO) plans. Express Scripts is a benefits reseller, not a benefits administrator. Ingredient and dispensing costs from pharmacies and rebates from Pharma flow first to Express Scripts who is allowed by contract to mark-up these costs or retain a portion of the rebates before passing them on to self-insured clients. In Wellpoint’s ASO plans, 100% of claim costs are passed directly to the client without flowing through the insurer’s financial statements.

Contracts of the Big 3 independent PBMs – Express Scripts, Medco, and CVS / Caremark -- do contain transparent management fees, but these pale in proportion to opaque margins made on pharmacy reimbursements and retained rebates. In a recent paper, we estimated that Medco’s management fees averaged \$6.52 per member per year (PMPY) while transactional gross profits averaged \$42.66 PMPY.⁴ If Medco’s business model were ASO instead of benefits reseller, it would have to charge management fees many times more than \$6.52 PMPY to cover overhead costs sufficient to maintain profitability.

Wellpoint’s PBM business is composed of a mix of plans covering the 25 million people and 265 million prescriptions per year. These plans include small and large employer plans, government employee plans, individual plans, and Medicare Part D plans. The plans also can

be categorized by business model – the basis a company chooses for collecting revenue and incurring costs.

Wellpoint has two basic business models: risky insurance contracts based on transparent fixed premiums and self-insured administration service only (ASO) contracts also based on transparent management fees.

While Wellpoint does not report any breakdown of **PBM** plans by business model, we can derive a rough approximation of this distribution from 10-K data on covered lives by **medical** plan type.⁵ This is presented in Table 1 below. Note that Wellpoint reports 35 million lives covered by medical plans but only 25 million lives covered by pharmacy plans. This means that a considerable number of customers already “carve-out” pharmacy benefits management and turn this over to an independent PBM.

Table 1: Wellpoint's 2008 Distribution of Covered Lives by Medical Plan Type

Medical	1,000s	%
Group Type		
Local Group	16,632	47.5%
Individual	2,296	6.6%
National Accounts	11,456	32.7%
Senior	1,304	3.7%
State Sponsored	1,968	5.6%
Federal Employee HBP	1,393	4.0%
	35,049	100.0%
Business Model		
Risk premium	16,529	47.2%
Self-Insured ASO	18,520	52.8%
	35,049	100.0%
PBM Covered Lives	25,000	

Table 2 presents our attempt at nesting group type within business model type. We assume that all national account, state-sponsored, the Federal Employee Health Benefit Plans (FEHBP) are self-insured ASO plans. We also assume that all individual and senior (Medicare) accounts are risky, fixed premium plans.

The only question is the distribution of local, small business plans by business model. Fortunately, this is only remaining group type and the amount is a “plug” once all the other line items are distributed. Table 2 is used later to estimate the potential to increase the profitability of Wellpoint’s book of business through business model conversion from low profit, risk premium plans to higher profit benefits reseller plans.

Table 2: Estimated Distribution of Wellpoint's PBM Covered Lives By Business Model

Risk Premium	
Local Groups	36.9%
Individuals	6.6%
Seniors	3.7%
<hr/>	
Total Risk Premium	47.2%
Self-Insured ASO	
<hr/>	
Local Groups	10.6%
National Accounts	32.7%
State-Sponsored	5.6%
Federal Employee HBP	4.0%
<hr/>	
Total Self-Insured ASO	52.8%

Express Scripts’ PBM business is composed almost entirely of self-insured plans. In the case of Medicare Part D prescription drug plans (PDPs), Express Scripts has chosen to avoid risk by becoming the “Intel inside” service provider to the nominal sponsor who must register with states as a risk-bearing entity.

Unlike the self-insured plans managed by Wellpoint and other large insurers, Express Scripts sets itself up as a benefits reseller with provider reimbursements flowing through Express Scripts' balance sheet. This reseller business model facilitates a deceptive pricing strategy where low ball, transparent management fees are subsidized by opaque transactional margins -- retail spread, retained rebates, and excess margins on generic drug prescriptions filled by captive mail order pharmacies.

Estimating the Premium Express Scripts Paid

Despite the reluctance to disclose detail, one day after the April 14th announcement of the deal, CEO Jerry Hall disclosed important detail in an interview granted to CFO.com.⁶ He noted that the key to the valuation of the deal was the projected cash flow of a 10 year contract to manage Wellpoint's PBM business. By subtracting a tax benefit of \$1 Billion – the present value of \$100 to \$125 Million per year over 10 years -- and a \$200 Million estimate for the value of physical assets, we derive an estimate in Table 3 below of Express Scripts' valuation of the 10 year contract in terms of implied EBITDA / Adj. Rx.

Assuming cash flow from the deal is equal to its delivered EBITDA, it follows that a yearly EBITDA of \$472 Million over 10 year at 6% interest underlies Express Scripts' net present valuation of \$3.475 Billion. Divide that by our estimate of Wellpoint's currently adjusted Rx under management of 284 million and we arrive at \$1.66 EBITDA / Adj Rx as a comparable metric of PBM valuation.

To realize a return over and above its purchase price of \$3.475 Billion, Express Scripts must generate more than \$1.66 EBITDA / Adj Rx from Wellpoint's PBM operations.

Table 3 : Estimate of EBITDA / Adj Rx Implicit in ESRX's Valuation of 10 Year Contract

Item	Row	Source	WLP - PBM millions
Total Purchase Price	r1	Note 1 below	\$ 4,675
ESRX Value of Tax Saving Structure of Deal	r2	Note 6 below	\$ (1,000)
Estimated Valuation of " Bricks & Mortar"	r3	Our estimate	\$ (200)
Value of 10yr Contract	r4	=sum(r1:r3)	\$ 3,475
Implied Yearly EBITDA flow over 10 yr at 6%	r5	NPV(r5 at 6%, 10 years) = 3,475	\$ 472
Adjusted script	r6	Table 5 Row 8 below	284
Implied EBITDA / adj Rx in ESRX valuation	r7	= r5 / r6	\$ 1.66

It is instructive to compare Express Scripts' valuation of \$1.66 EBITDA / Adj Rx with an estimate of what Wellpoint's PBM is generating now. This is done in Table 4, based on the key estimate that the Wellpoint PBM operation contributes less than 10% of the total company profit as reported by Dow Jones New Service reported Dinah Wisenberg Brin, based on interviews with Wall Street analysts.⁷

Table 4: Estimate of Current EBITDA / Adj Rx of Wellpoint's PBM

Item	Row	Source	WLP - PBM millions
EBIT	r1	2008 10-K	\$ 3,112
Amortization	r2	2008 10-K	\$ 428
Depreciation	r3	2008 10-K	\$ 105
Wellpoint EBITDA	r4	sum(r1:r4)	\$ 3,645
Wellpoint - PBM EBITDA @ 9%	r5	r4 * .09	\$ 328
Unadjusted Scripts	r6	Note 5	265
Adjusted Scripts	r7	Table 5 - row 8	284
Wellpoint PBM Current EBITDA / Adj Rx	r8	=r6 / r7	\$ 1.16
Implied EBITDA / adj Rx in ESRX valuation	r9	Table 3 - row 7	\$ 1.66
Current EBITDA / adjust Rx of Express Scripts PBM	r10	Table 5 - row 12	\$ 2.75

ESRX Valuation of Wellpoint PBM 10 Year Contract

Valuation represent a premium over current EBITDA or	r11	= (r9 - r8) / r8	43.7%
Valuation represent a discount over ESRX EBITDA	r12	=(r9 - r10) / r10	-39.5%

What was the thinking behind Express Scripts' valuation that caused it to be 44% higher than Wellpoint's current's profitability? And, why was the current profitability of Wellpoint's PBM so much lower than the 2008 profitability of both Express Scripts (ESRX) and Medco (MHS), as measured by EBITDA / Adj Rx, and summarized in Table 5 below?

Table 5: Comparison of EBITDA / Adj Scripts

Item	Row	WLP-PBM Source	WLP-PBM	ESRX	MHS	ESRX / MHS Source
Covered Lives	r1	Note 8 below	25	50	60	Note 9
Total scripts - unadjusted	r2	Note 1 below	265	420.4	586	2008 10-K
Generic dispensing rate - unadjusted	r3	Note 9 below	65%	66.2%	64.0%	2008 10-K
Mail Order penetration rate - unadjusted	r4	$= (r10) / (3 - (2 * r10))$	3.6%	9.7%	18.1%	$= r5 / r2$
Mail Order Rx - unadjusted	r5	$= r2 * r4$	9	41	106	2008 10-K
Mail Order Rx - adjusted	r6	$= r5 * 3$	28	122	318	2008 10-K
Retail Scripts	r7	$= r2 * (1 - r4)$	256	380	480	2008 10-K
Total Scripts - adjusted	r8	$= r2 * (1 + (2 * r4))$	284	502	798	2008 10-K
Adj Scripts / Cover Lives	r9	$= r8 / r1$	11.4	10.0	13.3	$= r8 / r1$
Mail Order penetration rate - adjusted	r10	Note 10 below	10.0%	24.4%	39.8%	2008 10-K
EBITDA	r11	Table 4 - r6	\$ 329	\$ 1,378	\$ 2,461	2008 10-K
PBM EBITDA / Adj Rx	r12	$= r11 / r8$	\$ 1.16	\$ 2.75	\$ 3.08	2008 10-K

To what extent are these differences in profitability due to superior negotiating power based on scale? How much is due to focused benefits management driving mail order penetration rates (MOPR) and generic dispensing rates (GDR)? In other words, how much is due to the ability of large independent PBMs to drive benefit management efficiencies that are split with customers in the form of lower prices with the rest going to EBITDA?

The Potential for MOPR to Drive EBITDA / Adj Rx

Currently, Wellpoint's adjusted mail order penetration rate (MOPR) is said to be less than 10%.¹⁰ What would be the EBITDA impact if Express Scripts could double that? Could that potential be the reason Express Scripts valued the deal at a 44% premium?

On the other hand, what if much of the difference between the deal price and valuation based on current profitability were not due so much to the potential for more efficient benefits management but the potential for business model conversion – switching clients from risky fixed premium contracts with low EBITDA / Adj Rx to opaque, transactional contracts with high EBITDA / Adj Rx?

In a related paper, we estimated the EBITDA impact of doubling Wellpoint's MOPR. This was derived from an estimate of the number of scripts moving from retail to mail order.¹¹ We also needed an estimate of gross profits per adjusted script of mail order generic and brand prescriptions.¹² Combining these in Table 6 below yields an estimate of the incremental EBITDA / Adj. Rx that can be achieved by a doubling of Wellpoint's MOPR. The result is that Express Scripts would barely cover the 44% premium it paid for Wellpoint. Something else must underlie their belief that they can generate a return significantly greater than \$1.66 EBITDA / Adj. Rx.

Table 6: Estimate of Incremental EBITDA from MOPR

	Source	Row	Generic	Brand	Total - \$ Millions
Incremental Rx through MOPR	Note 11 below	r1	16	16	
Gross Profits / Adjust Rx	Note 12 below	r2	\$ 7.67	\$ 1.95	
Gross Profits = EBITDA	$r3 = r1 * r2$	r3	\$ 123	\$ 31	\$ 154
Current EBITDA - Wellpoint PBM	Table 4 above	r4			\$ 329
Potential EBITDA via MOPR	$= r3 + r4$	r5			\$ 483
Adjusted Rx	Table 4 above	r6			284
Potential EBITDA / Adj Rx via MOPR	$= r5 / r6$	r7			\$ 1.70
EBITDA Implicit in Bid for Contract	Table 3 above	r8			\$ 1.66
Return on Investment as measured by incremental EBITDA over bid	$= r7 - r8$	r9			\$ 0.04
	$= r9 / r8$	r10			2.4%

Express Scripts' Unspoken Plan: Business Model Conversion

We believe that Express Scripts has plans for boosting EBITDA in addition to doubling Wellpoint's MOPR. Express Scripts' unspoken plan is to convert Wellpoint's clients to its benefits reseller model. However, there are certain segments of Wellpoint's book of business that can't be weaned from fixed premium insurance: individual plans and seniors enrolled in Medicare Part D plans.

At best, we estimate that Express Scripts will be able to convert half of small businesses to self-insured plans. That leaves Express Scripts with risk exposure amounting to about 29% of Wellpoint's book of business, as presented below in Table 7. At best, Express Scripts will be exposed to premium risk for 7 million covered lives or about 10% of its expanded book of business. This exposure is far more than Medco or CVS / Caremark.

Table 7: Estimate of Express Scripts' Exposure to Risk Premium

	Before	After
Risk Premium		
Local Groups	36.9%	18.4%
Individual	6.6%	6.6%
Senior	3.7%	3.7%
Total Fully Insured	47.2%	28.7%
Self-Insured fee for service		
Local Group	10.6%	29.0%
National Account	32.7%	32.7%
State-Sponsored	5.6%	5.6%
Federal Employee HBP	4.0%	4.0%
Total Self-Funded	52.8%	71.3%

Front #1: Wellpoint as the Underwriting Front with Express Scripts as the Risk-Bearing Entity

There are regulatory issues that accompany Express Scripts' take-over of Wellpoint's risky, fixed premium plans held by small businesses, individuals, and seniors under Medicare Part D plans.

While Wellpoint will remain as nominal underwriter of these contracts, the deal turns Wellpoint into a "front" while Express Scripts become the "risk-bearing entity". In other words, the Express Script – Wellpoint deal is a "fronting arrangement" according to the following definition from the Reinsurance glossary,¹³

In a fronting arrangement, the licensed insurer (ceding company) that obtains regulatory approval for an insurance product, sells the product, and cedes all or most of the risk to a company that is not licensed to do business in the jurisdiction.

State governments have the responsibility for licensing "risk-bearing entities". They do this by requiring that such entities have adequate reserves on their balance sheets to cover potential losses, and by requiring that periodic financial statement be filed as support. Determining status as a risk-bearing entity and the need for licensing has presented state regulators with a number of problems in the healthcare area.

For example, physician group practices and hospitals sometimes accept capitated contracts providing them with a fixed PMPY fee regardless of actual patient usage. Such contracts involve a degree of risk and have raised the question for the need of physician practices and hospitals to be licensed as risk-bearing entities. The trend toward capitated payments will increase if healthcare reform involves replacing usage as the basis for reimbursements.

Another area presenting problems to state regulators has been independent PBMs who accept outsourced contracts from insurers or plan sponsors. Normally, outsourced benefits managers operate on a no-risk ASO model where all healthcare costs flow directly to the insurer or plan. However, the Big 3 PBMs operate on a benefits reseller model with reimbursements flowing through their balance sheets. In this case, there is some risk of failure to reimburse providers due to lack of working capital.

Generally, the Big 3 PBMs avoid underwriting fixed premium pharmacy benefits contracts. For example, they have preferred to be the “Intel-inside” Medicare Part D prescription drug plans (PDPs), avoiding exposure to the risk inherent in these government-subsidized, but nevertheless, capitated plans. However, both Medco, under its own name, and CVS/ Caremark, under the name Silverscript, have decided to position themselves as direct sponsors of Medicare Part D PDPs. Accordingly, they have created insurance subsidiaries that they have registered in just about every state.

On the other hand, Express Scripts has avoided positioning itself as a direct sponsor of Medicare Part D PDPs. While they have created an insurance subsidiary, it has been licensed and reports activity in only a few states relative to the insurance subsidiaries of Medco and CVS/Caremark. The following statement from the latest 10-K of Express Scripts summarizes its position on state insurance regulations:¹⁴

Fee-for-service prescription drug plans are generally not subject to financial regulation by the states. However, if a PBM offers to provide prescription drug coverage on a capitated basis or otherwise accepts material financial risk in providing the benefit, laws in various states may regulate the plan. Such laws may require that the party at risk establish reserves or otherwise demonstrate financial responsibility. Laws that may apply in such cases include insurance laws, HMO laws or limited prepaid health service plan laws.

Currently, the Company does not believe that its PBM business currently incurs financial risk of the type subject to such regulation. However, if it chooses to become a regional PDP for the Medicare outpatient prescription drug benefit at some time in the future, the Company would need to comply with state laws governing risk-bearing entities in the states where it operates a PDP.

Below is a table published by the National Association of Insurance Commissioners listing the 2008 business activity undertaken by Express Scripts' insurance company in the 13 states where Wellpoint's PBM book of business is located.¹⁵ Note that there are 5 states – Colorado, Kentucky, Maine, Nevada, and New Hampshire -- where no activity has been reported. Also, notice that in 10 states, Express Scripts' status is below that of "fully licensed".

Express Scripts plan's for Wellpoint's PBM business should be monitored closely by state insurance regulators. Insurance regulators in the states where Wellpoint-Anthem currently does business should consider Express Scripts as a risk-bearing entity in light of their purchase of Wellpoint's PBM book of business.

Front #2: Wellpoint as the SG&A Front with Express Scripts Paying Fees-for-Service

Express Scripts has talked only about realizing value through more efficient benefits management, starting with improving the mail order penetration rate (MOPR). Neither Express Scripts nor Wellpoint has mentioned anything about cost-saving or profit-enhancement via leveraging overhead costs.

Yet, when we talked to a Wall Street analyst, leveraging overhead was the first thing mentioned as a potential driver of value in this deal. Leveraging overhead has been one of the stated financial benefits of horizontal mergers involving PBMs.

EBITDA per adjusted script can be increased in a horizontal merger of PBMs via spreading fixed overhead costs over a greater volume of scripts managed. For PBMs and integrated insurance companies, overhead is aggregated into one line called “sales, general, and administrative” (SG&A) in their reported financials. Note, though, that labor and facilities costs associated with captive mail order pharmacies are accounted for as manufacturing costs and included in the cost of sales line rather than the SG&A line.

The potential to leverage overhead in this particular deal is much less than what could be obtained via a merger of two single line-of-business PBMs. This is because Wellpoint is an integrated insurance company with overhead driven by **account management** rather than **product management**. The sale of a product line secondary to their core medical benefit business, such as PBM or disease management, would not change Wellpoint’s SG&A costs much because the number of customer accounts and the need to manage their core medical benefit remain the same.

The financial rationale for a medical insurance company to “carve in” PBM, or for that matter, other benefits management operations, is that the incremental benefits of integration out-weight any incremental losses due to lack of specialization.

We believe that this deal will be structured to overcome the trade offs involved in normal PBM carve-outs by integrated insurance companies – specialization gains offset by SG&A losses. A quote from Wellpoint CEO Angela Braly is an example of the “best of both worlds” vision for this deal. She mentions that the MOPR and PBM IT will be two sources of incremental efficiencies derived by carving out PBM to a specialist. At the same time, she is clear that deal would not result in a complete transfer of management responsibilities.¹⁶

Wellpoint will retain control of medical policy, formulary and integrated disease management, and will work alongside Express Scripts to offer best-in-class pharmacy management and data analytics. Wellpoint members will gain access to better Web, home delivery and customer service capabilities, and clients will benefit from enhanced reporting.

As might be expected, neither party has acknowledged potential integration losses from this carve-out. While we have nothing new to offer about the impact of integrated management of medical and pharmacy benefits on healthcare costs, we can say something quantitatively about the potential SG&A losses if there is a complete transfer of all PBM SG&A responsibility to Express Scripts.

Table 8 below presents an estimate of aggregate SG&A / Adjusted Rx for Wellpoint (WLP), Express Scripts (ESRX), and Medco (MHS). The estimates for Express Scripts and Medco come straight from their 10-K's with no additional assumptions. However, the estimate for Wellpoint assumes that each of Wellpoint's businesses has the same ratio of SG&A to EBITDA, which is equal to the aggregate ratio of SG&A to EBITDA. Based on this assumption, we arrive at an estimate for Wellpoint's PBM SG&A at \$2.89 per adjusted script versus \$1.71 for Express Scripts and \$1.98 for Medco.

Table 8: Comparison of SG&A and Gross Profits / Adj Scripts

Item	Row	Source	WLP-PBM	ESRX	MHS	Source
Sales, General, & Administrative (SG&A)	r1	2008 10-K - 9%	\$ 812	\$ 760	\$ 1,425	2008 10 K
Depreciation	r2	2009 10-K - 9%	\$ 9	\$ 98	\$ 158	2008 10 K
SG&A -Before Depreciation	r3	=r1 - r2	\$ 821	\$ 858	\$ 1,583	=r12 - r13
Adjusted Scripts	r4	Table 5 r8	284	502	798	Table 5 r8
SG&A -BITDA / Adj Rx	r4	=r14 / r15	\$ 2.89	\$ 1.71	\$ 1.98	=r14 / r15
Difference from WLP-PBM				\$ 1.18		

There is something wrong with this estimate. Because a medical benefit is much more complex to manage than a pharmacy benefit and medical is core to Wellpoint while pharmacy is an add-on, it seems appropriate to assume pharmacy's ratio of SG&A to EBITDA is much lower than medical's ratio of SG&A to EBITDA.

The \$2.89 figure in Table 8 is too high of an estimate. On the other hand, if we could truly estimate Wellpoint's *incremental* cost of managing pharmacy benefits, we believe that it would be less than Express Scripts' \$1.71 figure. Despite the averages presented in Table 8, Wellpoint, not Express Scripts, is the more efficient entity at managing PBM SG&A costs, especially the sales component, because of its ability to leverage account management costs over multiple product lines.

If Express Scripts assumes complete SG&A responsibility for Wellpoint's book of business, it could expect to incur an incremental cost somewhat less than its current average of \$1.71 due to increased script scale. On the other hand, Wellpoint might be willing to remain responsible for most of the SG&A function for a fee that covers the incremental SG&A cost of managing its own book of business. Because of account management leveraging, we believe that this incremental cost is around \$1.00, much less than Express Script figure of \$1.71.

In Table 9, we take this analysis a step further by reconstructing Wellpoint's PBM gross profits using a more realistic SG&A application rate of \$1.00 per adjusted script. Given the current estimated EBITDA of \$1.16, this implies a current estimated gross profit per adjusted script of \$2.16.

**Table 9: Comparison of WLP and ESRX Financials
Using a More Realistic SG&A Application Rate**

			WLP-PBM	ESRX	Difference	
Est. Gross Profits / Adj Rx	r1	=r3 - r2	\$ 2.16	\$ 4.46	\$ (2.30)	=r3 - r2
Less: SG&A Application Rate	r2	estimate	\$ (1.00)	\$ (1.71)	\$ 0.71	Table 8 r4
PBM EBITDA / Adj Rx	r3	Table 5 r 12	\$ 1.16	\$ 2.75	\$ (1.59)	Table 5 r 12

The differences in profitability between these two PBMs is much more than the EBITDA difference of \$1.59. It is closer to the estimated gross profit difference of \$2.30 which is derived from a SG&A application rate that better reflects the incremental SG&A costs driven by the PBM business.

The Wellpoint – Express Scripts dealmakers are facing the following dilemma: how to structure the deal to take advantage of Express Scripts' expertise in PBM and business model conversion while preserving Wellpoint's strength in leveraging SG&A through account management.

We believe that Wellpoint will continue to be responsible for routine SG&A management while Express Scripts will be active when it comes to promoting changes in plan designs and business models. Consistent with this division of responsibility, it is likely that Express Scripts will be making substantial payments back to Wellpoint for its administrative work.

The first priority of Express Scripts will be to indoctrinate the Wellpoint organization on the importance of promoting mail order. They will urge the Wellpoint organization to promote mail order an "opt out" rather than a "opt in" option. The second priority will be to have Express Script people directly responsible for the pharmacy benefits management portion of the largest ASO plans with over 1,000 members. The objective here will be to try to convert these plans to a benefits reseller model. The third objective will be to try to convert all fixed premium clients over, say 150 members, to a self-insured ASO model.

This deal will not be a clean transfer of a book of business. Wall Street analysts are beginning to recognize the complexity of this deal and are uncomfortable with statements that the deal won't close until 4Q2009. Consider the following statement made by Express Scripts CEO George Paz during their 2Q2009 conference call with Wall Street analysts hinting at the need to include fees-for-service so that "Wellpoint has a very strong vested interest in making sure that the service level stay intact and the asset performs." ¹⁷

(Express Scripts CEO) George Paz

..As you know, when you buy any asset, you typically want that asset in your possession as soon as possible because... in most typical transactions, quite frankly (the selling party) loses interest in that asset because it's not going to be theirs going forward. And that's why people rush to close. It's extremely important to get that asset in your possession, one's possession in order to manage it and maintain it.

This is far different than that. This is both an alliance and an acquisition. And unlike most deals where we have to bring up a deal, and then try to convert the numbers and then try to seek out the economics of the deal over the first year to two years, here we want to make sure because Wellpoint has a very strong vested interest in making sure that the service level stay intact and the asset performs. So although the seller, they meet with us on a daily basis. So, both teams are heavily engaged in this and there isn't a rush to closure. There is a 10-year alliance that begins on 1/1.

In sum, the deal is likely to include a complex division of SG&A responsibilities and open-ended fee arrangements which will cause on-going and long term tension between Express Scripts and Wellpoint.



Express Scripts Ins Co

NAIC#: 60025

Home Office: Arizona

Business Type: Life/Accident/Health

Other Reports: [Complaints](#) [Financial Information](#)

[Company Search Help](#)

EXPRESS SCRIPTS INS CO
 LICENSED STATE REPORT
 YEAR END 2008

State	Active Status	Direct Business Written
California	E	\$226281
Colorado	E	\$0
Georgia	E	\$339422
Indiana	L	\$452563
Kentucky	E	\$0
Maine	E	\$0
Missouri	E	\$452563
Nevada	L	\$0
New Hampshire	E	\$0
New York	L	\$1357688
Ohio	E	\$113140
Virginia	E	\$113140
Wisconsin	E	\$452563

Legend for Active Status column

L - Licensed or Chartered	Licensed Carrier and Domiciled Risk Retention Groups. In some states referred to as admitted.
R - Registered	Non-domiciled Risk Retention Group
E - Eligible	Reporting Entities eligible or approved to write Surplus Lines in the state. In some states referred to as non-admitted.
N - None of the above	Not allowed to write business in the state.
Q - Qualified Reinsurance	
"-" - Unknown	Status could not be determined

Notes

- (1) Reed Aleson, "Wellpoint Sells Its Pharmacy Benefits Division, NYT April 13, 2009. Available at <http://www.nytimes.com/2009/04/14/business/14drug.html>
- (2) Wellpoint 1Q2009 Conference Call, transcribed and posted by Seeking Alpha. Available at <http://seekingalpha.com/article/132352-wellpoint-inc-q1-2009-earnings-call-transcript?page=9>
- (3) Seeking Alpha, "Express Scripts 2Q2009 Earning Call Transcript," July 31, 2009 Available at <http://seekingalpha.com/article/152881-express-scripts-inc-q2-2009-earnings-call-transcript?source=yahoo&page=1>
- (4) LW Abrams, "Quantifying Medco's Business Model: An Update," November, 2008. Available at http://www.nu-retail.com/Medco_Business_Model_An_2007-2008_Update.pdf
- (5) Estimated of Wellpoint's distribution of contracts by type is available at <http://industry.bnet.com/healthcare/1000204/wellpoint-holds-the-line-for-now/>
- (6) David M, Katz, cfo.com, "Want to Add a Decade of Cash Flow? Buy it," April 15, 2009, Available at http://www.cfo.com/article.cfm/13491841/c_13481387?f=home_todayinfinance
- (7) Dinah Wisenberg Brin, "Express Scripts' Wellpoint PBM Buy Benefits Both Cos. April 13, 2009 Dow Jones New Service. Available at <http://online.wsj.com/article/BT-CO-20090413-707061.html>
- (8) Estimate of the number of lives covered by various PBMs available at http://www.aishealth.com/MarketData/PharmBenMgmt/PBM_market01.html
- (9) Samuel R. Nussbaum, "Wellpoint Strategies for Transparency in Cost and Quality, PowerPoint presentation to the Center for Health Transformation, December 9, 2008, Available at <http://www.healthtransformation.net/galleries/default-file/WellPoint,%20Inc.%20Presentation.pdf>
- (10) Tracey Walker, "Industry Analyzes Wellpoint PBM Buy," May 1, 2009 Managed Healthcare Executive. Available at http://www.silobreaker.com/industry-analyzes-wellpoint-pbm-buy-5_2262287240132558858
- (11) LW Abrams, "De-Capitation: Express Scripts' Unspoken Plans for Its Wellpoint PBM Acquisition," May 2009. Available at http://www.nu-retail.com/The_Express_Scripts_Wellpoint_PBM_Deal.pdf
- (12) LW Abrams, "Quantifying Medco's Business Model: An Update," November, 2008. Available at http://www.nu-retail.com/Medco_Business_Model_An_2007-2008_Update.pdf
- (13) Definition comes from The Reinsurance Glossary, Available at <http://www.findalink.net/reinsurance/def-f.php>
- (14) Express Scripts, 10-K Statement for the Year Ending December 31, 2008. Available at <http://yahoo.brand.edgar-online.com/DisplayFiling.aspx?dcn=0000885721-09-000015>
- (15) National Association of Insurance Commissioners, Consumer Information Source, Available at <https://eapps.naic.org/cis/index.do>
- (16) Joint Press Release, April 13, 2009 Available at <http://phx.corporate-ir.net/phoenix.zhtml?c=69641&p=irol-newsArticle&ID=1275340&highlight>

(17) Seeking Alpha, "Express Scripts 2Q2009 Earning Call Transcript," July 31, 2009 Available at <http://seekingalpha.com/article/152881-express-scripts-inc-q2-2009-earnings-call-transcript?source=yahoo&page=1>