Cigna Corporation and Express Scripts: a $67bn deal for their survival in the US healthcare industry

CIGNA Corporation (NYSE:CI) – market cap as of 09/03/2018: $42.7bn
Express Scripts Holding Co (NASDAQ:ESRX) – market cap as of 09/03/2018: $45.7bn

Introduction

On March 8, 2018, Cigna Corporation announced the acquisition of Express Scripts Holding for a cash and stock consideration of $67bn. The combination of Cigna – a health insurance firm – and Express Script – a pharmacy benefit management ("PBM") organization – is part of a broader trend amongst large players to vertically integrate the downstream pharmaceutical supply chain.

About Cigna

Cigna Corp. is a global health insurance company, headquartered in Bloomfield, Connecticut (USA). It operates in 30 countries with around 37,000 employees.

Cigna was established in 1982 through the merger of the Connecticut General Life Insurance Company (CG) and INA Corporation (the first marine insurance company in the USA). The main segments in which this company operates are: Global Health Care, Group Disability, Global Supplemental Benefits and Life, and Other Operations divisions. The business offers a variety of insurances, such as health, life and other insurance products and distributes them mainly through insurance consultants and brokers.

In 2015, Anthem Inc. – another major US health insurer – announced an offer to acquire Cigna for more than $47bn: the deal was however blocked by the US Justice Department, which filed for an antitrust litigation.

About Express Scripts

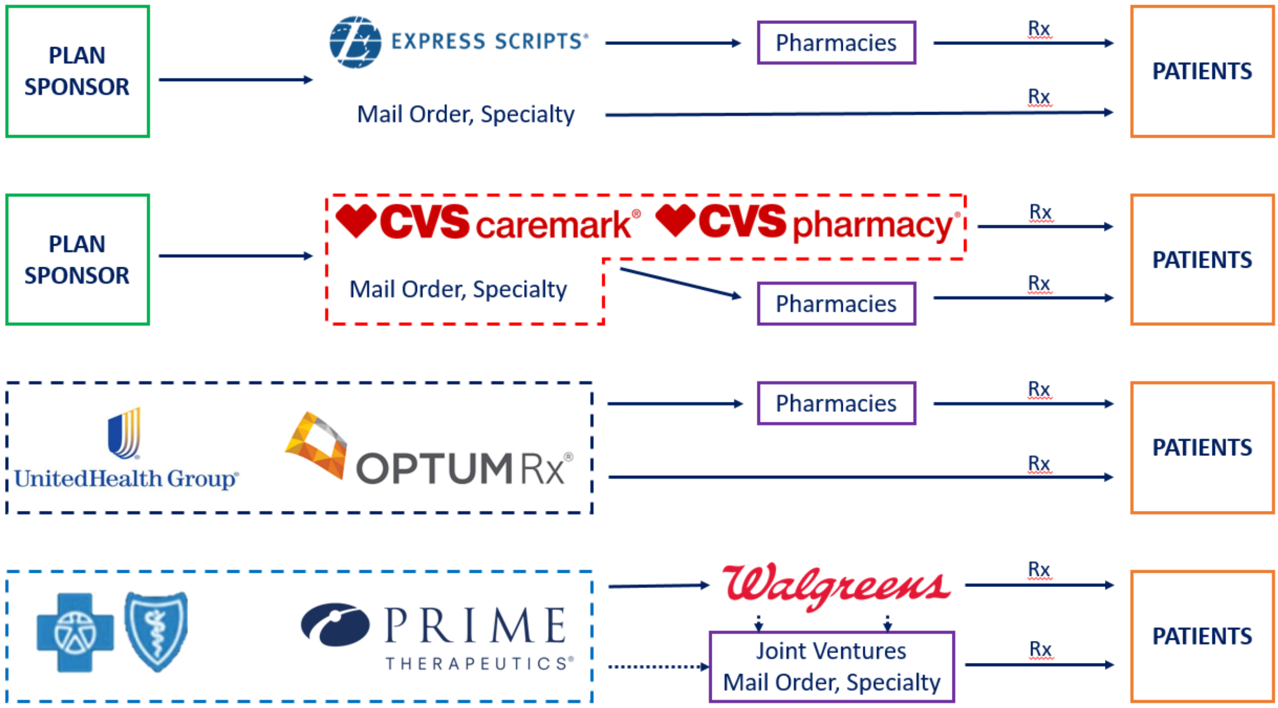
Express Scripts is the largest pharmacy benefit management (PBM) organization in the United States. PBMs act as an intermediary between pharmaceutical companies and insurance companies. Their primary focus is on contracting pharmacies and negotiating discounts with drug manufacturers as they are buying in aggregate for their clients (insurers and employers).

The company was established as a joint venture between a chain of pharmacies (Medicare Glaser Inc.) and Sanus Corp. Health Systems. It became publicly traded in 1992 after it was purchased by New York Life Insurance Company. Over the period 2007 – 2012 it has been expanding through a series of acquisitions of other PMBs operating in US. The acquisition of Medco established Express Scripts as the market leader, with 1.5 billion claims.

Currently, it has more than 90 owned or leased PBM facilities throughout the US and seven owned or leased PBM facilities in Canada. It serves over 3,000 customers including managed care organizations, insurance carriers, third party administrators, employers, and union-sponsored benefit plans. Anthem, Express Scripts' largest customer, accounts for 15% of total revenues but did not renew its contract ending in 2019. Anthem has instead decided an in-house PBM largely using CVS infrastructure.

The key services of Express Scripts include processing of network-pharmacy claims and distribution of medications. The company operates through a network of retail pharmacies. The distribution, however, is handled through the automated pharmacies dispense system and direct home delivery (the latter for medications for long-term chronic diseases like diabetes). Segment revenue is primarily derived from core PBM (includes home delivery) and the specialty pharmacy segment, which account for 71% and 21% of revenue respectively.

Industry overview



The drug delivery system in the US is composed of insurers & sponsors, PBMs, and pharmacies. The threat from Amazon, increasing competition within the industry, and public scrutiny to grow the industry by cutting costs has led companies to search for M&A. However, horizontal bids such as Anthem's bid for Cigna (health insurers), Aetna's bid for smaller rival Humana (PBMs), and Walgreens bid for Rite-Aid (pharmacies) all failed due to cited antitrust issues. As an alternative, parties turned to vertical integration. CVS Health, which owns Express rival Caremark, recently acquired Cigna's competitor Aetna (this is pending approval), while Optum (a PBM and health service provider owned by the giant United Technologies) will incorporate, pending approval, the recent acquisitions of around 300 medical clinics and ambulance health services from DaVita Medical Group, in a deal valued nearly $5bn. This left Express Scripts as the only remaining standalone PBM with scale.

In 2016, the US pharmacy distribution and reimbursement system enabled more than 5 billion equivalent prescriptions to be dispensed and paid, while $412bn were generated in final sale revenue at retail, mail, long-term care, and specialty pharmacies. It follows that the average cost per prescription was $82, while the average American consumed 15 prescriptions per year (although averages are not entirely useful in this case because Americans are the largest consumers of prescription drugs in the world). In the next 2 years, Express Scripts expects 800 million claims to be up for bit in the next few years.

The key trend intensifying the industry competition (and thus companies' willingness to merge) and slowing growth is the plateau in generic dispensing rates. As the market has matured, the pressure on pharmacy profits has increased. For PBM's, generics represent a higher volume and generate higher margins in comparison to branded drugs when taking advantage of the spread between what insurers pay and what they pay out to pharmacies. Specialty drugs, which remain a faster growing segment but at lower volume, is concentrated amongst the larger PBM's (Market share: Express Scripts – 20%, CVS – 30% and Walgreens – 10%). The importance of the channel is rising, as specialty drugs become an ever larger portion of drug spending. Specialty drug spending is projected to rise to 42% of total spending by 2021, from 28% in 2016, according to Bloomberg.

One of the risks affecting the PBM industry is the close political inspection that such organizations have been subject to. Senate HELP (Health, Education, Labor and Pensions) Committee hearings on drug pricing in 2017 saw manufacturers and members of the drug-delivery system blame each other. As a result, one of the largest health insurer in US, UnitedHealth, announced on March 6 that it will begin passing along negotiated pharma rebates to customers. Since there is currently a strong public pressure on health insurers and PBM organizations, the decision of United Health may force PBM companies to follow similar strategy and offer their clients an option of sharing the entire discount directly with customers.

Deal structure

Cigna and Express Script agreed on a cash-and-stock deal valuing Express Script's equity at roughly $54bn and the enterprise value at $67bn. Cigna would pay $48.75 in cash and additionally give 0.2434 of the combined shares per Express Scripts share. Altogether, this translates to $96.03/share. According to S&P Global data, the premium paid to the price of Express Scripts before the deal announcement (so called undisturbed share price) amounts to 26%.

Once the transaction is closed, the shareholders of Cigna will own around 64% of the newly combined company, which leaves the remaining 36% for the shareholders of Express Script. Additionally, Cigna will take on $15bn of debt from Express Script: since Express Script held $2.3bn cash and cash equivalents at the end of 2017, this is equivalent to about $13bn of net debt.

In terms of funding, the deal will use a combination of available cash and newly issued debt. Overall, this will bring the combined entity value of total debt to an estimated $41.1bn, implying a 49% debt to total capital ratio.

Deal rationale

Concerns over rising healthcare costs and the possibility of powerful new entrants are catching up with the existing players. The deal, indeed, is just the latest in the wave of consolidation that is sweeping through the healthcare industry.

The $67bn Cigna's acquisition of Express Scripts – together with all the acquisitions which have recently interested the industry – is sending a signal that businesses have to acquire scale to tackle the increase in costs. Indeed, by getting bigger, Cigna hopes to increase its bargaining power to exploit greater leverage in price negotiations when buying drugs and services from pharmaceutical companies, as well as from doctors and hospitals that provide patient care – which represents around 60% of the US healthcare spending.

On the other hand, insurers have expressed the need to integrate the delivery of care and pharmacy benefits into their own operations in order to remain competitive. Thus, by bringing under the same roof both pharmacy and medical claims, the acquisition would eventually benefit consumers by allowing the two companies to furtherly improve treatments and lower costs. Adam J. Fein, the CEO of the Drug Channels Institute, one of the country's foremost experts on pharmaceutical economics and channel strategy, said the recent mergers may lead to better coordination because the companies will be looking at the healthcare business from multiple angles.

However, even if soaring costs are the staple of most of the anxiety of healthcare operators, companies are also reacting to likely threat of new powerful rivals entering the fight. As Roger Longman (chief executive of Real Endpoints, a health analytics company) said, "corporates are really angry that insurance vendors like Cigna have been unable to contain the increase in costs". That anger ended up prompting the formation of many alliances among large companies. For instance, in January, Amazon, JPMorgan Chase and Berkshire Hathaway announced plans to team up to address ascending health care costs, described by Warren Buffett as a "growing tapeworm on the American economy." Hence, the presence of new behemoth players in the business is taking on existing insurers and pharmacy benefits managers putting substantial pressure to streamline their operations, control prices and lower their operating costs.

Market reaction

Following the announcement on March 8th, Cigna's share price plunged 11.5% to $172/share, a signal that analysts interpreted as a response to the skepticism investors have about Express Scripts and the PBM business. On top of that, Cigna is also considered to have a limited footprint in the faster-growing Medicare and Medicaid government-sponsored business. On the other hand, Express Scripts' stock jumped 8.6% to close at $79.72 a share, reflecting investors' confidence that the deal will enlarge the client base and make the two companies stronger together.

Financial Advisors

Morgan Stanley is acting as sole financial advisor and it also provided a fairness opinion to the Cigna Board of Directors. Centerview Partners and Lazard are acting as financial advisors to Express Scripts. Debt financing for the deal is going to be provided by Morgan Stanley Senior Funding and The Bank of Tokyo-Mitsubishi UFJ Ltd.