UCONN

SCHOOL OF BUSINESS

STUDENT MANAGED FUND

CINZIA ALFANO & KELLY MCCOURT

APRIL, 2015

EXPRESS SCRIPTS®

Business Summary

Key Financial Metrics

Stock Price: $84.88
52-Week High: $88.83
52- Week Low: $64.64
FCF/Share (LTM): 5.57
FCF Yield: 6.6%
Beta: .78

Market Cap: 62,049M
P/E Ratio: 25.92
EPS: $4.88
ROIC: 6.83%
ROA: 3.74%
Debt/Com Equity: 67.7%

Sector: Health Care
Industry: Health Care Supply Chain
ROE: 9.58%
Gross Margin: 7.86%
EBITDA: $5,845
Debt/Assets: 25.2%

Stock Performance vs. SP500 (1 Year)

Corporate Information

Management:
CEO: George Paz
President: Tim C. Wentworth
Exec VP/CFO: James M. Havel

Headquarters:
St. Louis, MO

Employees:
29,500 (As of Dec. 31, 2014)

Business Summary

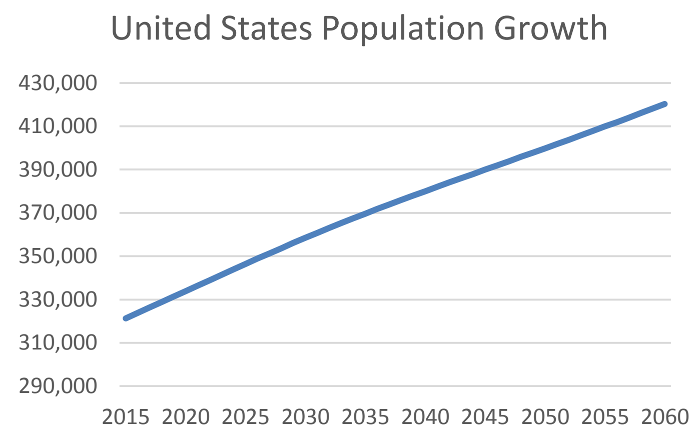
Express Scripts is a pharmacy benefit manager (PBM) primarily offering services in the United States and Canada. A PBM's primary role is to provide healthcare and prescription management on behalf of its clients. The company's PBM services operate primarily through a large retail pharmacy network, but also increasingly through a direct mail delivery system. The business also includes drug formulary management, clinical solutions, and other drug interaction studies. Express Scripts makes money by taking spreads between the negotiated and charged price.

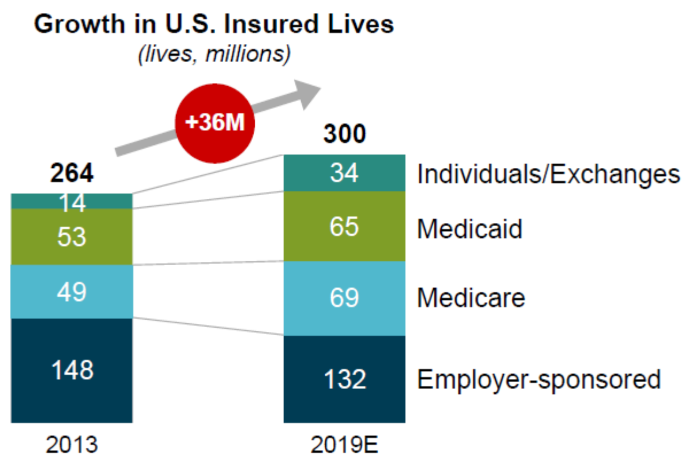
More specifically, Express Scripts' business segments include network pharmacy claims processing, home delivery pharmacy services, specialty pharmacy benefit management, drug utilization reviews, formulary management, and others. The majority of its revenue comes from its network services and mail-order businesses, which are 62% and 38% of its revenues, respectively. Part of what has contributed to its increase in size has been the Medco acquisition, which occurred in 2012 and increased Express Scripts' Medicare presence, warehouse capacity, and claim volume. Until now, the company's focus has been on increasing volumes but is seeing it shift towards operational efficiency. Going forward, the company is extremely well positioned to continue to grow as The Affordable Care Act comes into effect and as it continues on fully integrating Medco's business.

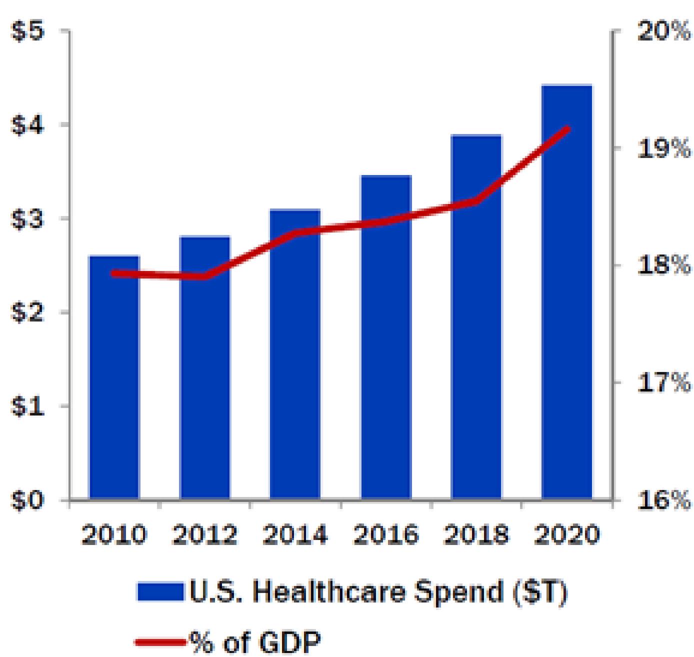
Health Care Overview

As a whole, the healthcare sector is experiencing unprecedented changes given the political environment of the United States. The Affordable Care Act (ACA) has been coming into effect, with the enrollment date for non-insureds to sign up for The ACA just closing on February 15th, 2015. Over 11 million people have signed up for insurance, and 1/3 of those people are under 35. This is a positive sign for the healthcare industry, as the overall market size will increase and thus provide growth for many companies in this industry.

The healthcare industry is promising to investors given the high growth, the changes in policies, and the high barriers to entry that exist within the industry. Healthcare spending made up approximately 18% of GDP spending in 2013, and is estimated to be $4 Trillion by 2020, or 20% of total GDP. Further, Medicare constitutes up to 20%-25% of state budgets and the number of people aging into Medicare is expected to grow at 8.5% compounded annually. This would provide immense growth opportunities for the Healthcare Sector, specifically PBM businesses that profit from high volume. Increased spending is supplemented by an increasing population. The United States population is expected to surpass 400 million people around 2050. Not only is this sector experiencing high growth, but it also has many barriers to entry that exist given government regulation and the overall healthcare ecosystem. It would be extremely difficult to penetrate an industry like Pharmacy Benefit Management given the deep networks that they have embedded within their business models, as well as the high capital requirements.



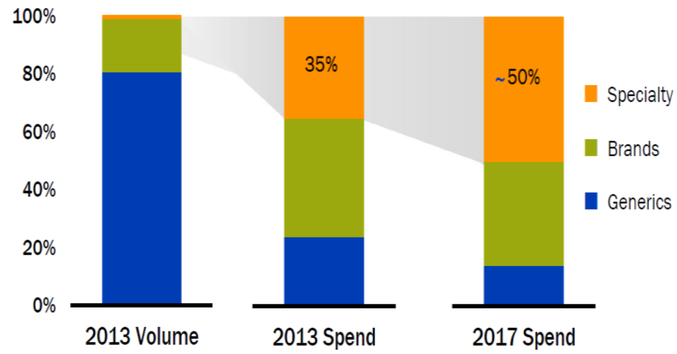


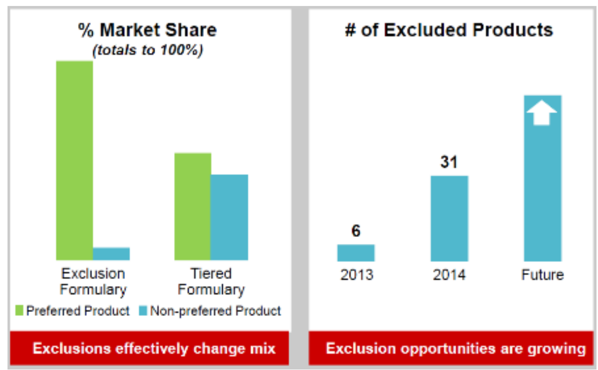


Pharmacy Benefit Management Industry

The Pharmaceutical Benefit Management sector is in the mature phase of its life cycle. As such, the industry is characterized by consolidation, merger and acquisition activity and a shift in focus toward operational efficiency. This was seen by both Express Scripts' acquisition of Medco, and the recent merger between Catamaran and OptumRx. Consolidation has heightened with the influence of macroeconomic trends that impact the industry, including rising drug costs, higher consumer spending on healthcare, and the Affordable Care Act. Specifically, the Affordable Care Act, which regulates prices and health insurance benefits, leaves less room for competition. Instead of consolidating to increase competition between companies by offering cheaper prices, companies are consolidating because they can create internal efficiencies and have more negotiating power without reducing prices, thereby making the firms more profitable.

In terms of trends, rising drug costs, higher prescription drug use, and increased healthcare spending have caused the PBM industry to grow significantly for the last 5 years. Specialty drug spending is expected to grow yearly, and will eventually make up 50% of the costs. This will increase the need for PBMs to provide cost management services. Given the deep relationships that PBMs have with various members of the health care network, health insurers have been increasingly turning to PBMs for their cost management services, and it is expected that Express Scripts can decrease specialty drug costs by 15%. Their ability to leverage discounts from drug wholesalers, as well as their formulary plans, has given each company the ability to become a dominant player in the industry, and the number of specialty drugs, and therefore potential exclusions is expected rise in the future. Further, the industry experiences medium to low use of capital, and it is expected that for every $1.00 spent on labor, $0.32 is spent on capital. This would mean that barriers to entry can be considered high given the capital requirements as well as the deep networks that are required to provide administrative services and discounts.





Competitive Landscape

PBM Total Revenue ($MM):	2014 Q4: $64,352.5		2013 Q4: $56,592.7	
Express Scripts	25,661.9	39.9%	25,126.1	44.4%
CVS Caremark	23,874.0	37.1%	19,615.0	34.7%
UnitedHealth Group (OptumRx)	8,807.6	13.2%	6,868.0	12.1%
Catamaran Corp	5,695.6	8.9%	4,489.6	7.9%
Cigna PBM Business	614.0	1%	494.0	.09%

PBM Total Revenue ($MM):	Network Claims	Home-Delivery
Express Scripts	52.1%	60.7%
CVS Caremark	47.9%	39.3%

Express Scripts holds a dominant position in both the PBM and Home Delivery markets. Both markets can be described as a near-oligopoly, with Express Scripts and CVS Caremark being the strongest players, each with over 1/3 of the total PBM revenues and sharing significant portions of the network and home-delivery claims. The industry has been seeing some changes, specifically in regards to the movement of PBM businesses being brought "in-house" by either health insurance companies or retail pharmacies. As of March 30, 2015, UnitedHealth Group, which owns OptumRx, has decided to purchase Catamaran in order to provide more enhanced services and cost benefits to clients. The combined company will have approximately 21% of PBM market share, making it the 3rd largest competitor in the industry.

Risk Factors

Pricing Pressure: The consolidation of the PBM industry has threatened the competition and will be able to tighten pricing. UnitedHealth's purchase of Catamaran has put the company on par with CVS Caremark, as they are both expected to process approximately 1B in scripts. This will result in increasing pricing pressure a competitors that may not have as significant scale.

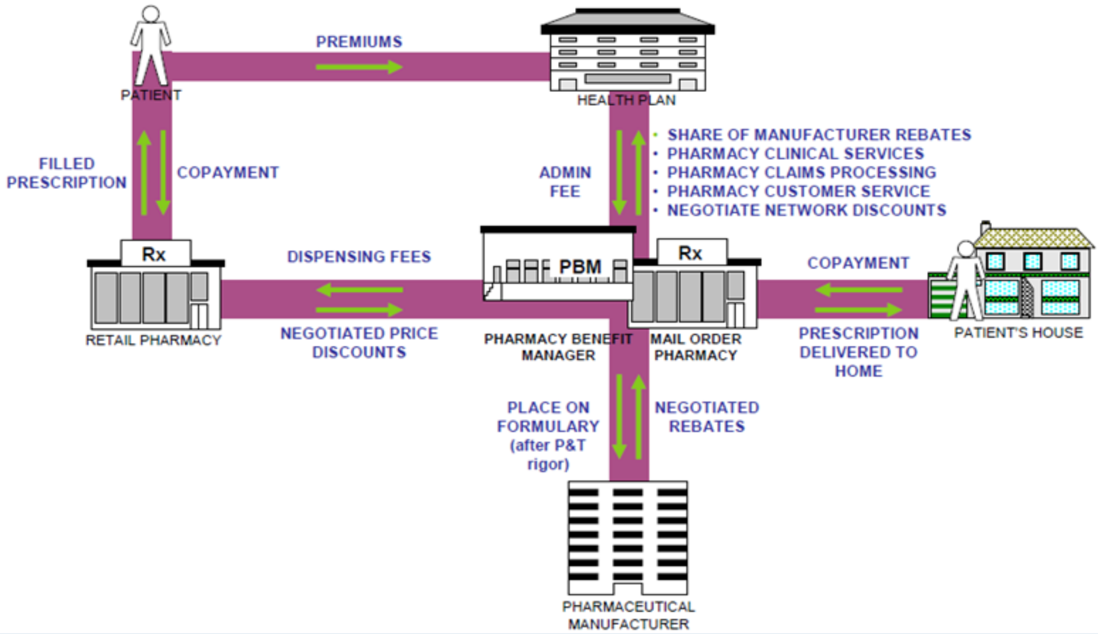
Technology and Data: Information is very important in the Heath Care industry, particularly for pharmaceutical companies who rely on successful clinical trials. The retail pharmacies have the best access to compiling and storing such data and can leverage this in the future to regain more control lost to PBMs. Unless Express Scripts can anticipate this change, they can lose some of their competitive advantage which is founded on negotiating power.

Government Changes: The Affordable Care Act has greatly benefited Express Scripts and other Pharmacy Benefit Managers. However, the government also has the power to create legislation that may not be advantageous to PBMs. Currently, Express Scripts does not have to disclose the spread between what it charges customers and the negotiated prices. Legislation that makes customers more informed will likely affect pricing.

Generic Drug Availability: Express Scripts depends on generic drugs as a cheaper alternative to comparatively expensive treatments. The generic drug market is currently very active; however, as specialty drugs become more prominent, generic alternatives may not be as readily available. While this negatively impacts the 'Network Revenues' it positively impacts the 'Specialty Drug and Home Delivery Revenues,' where Express Scripts is well poised in the market.

Contract Changes: Client contracts are typically 3-year contracts, mitigating risks that clients will quickly change Pharmacy Benefit Managers. However, pharmaceutical manufacturer and retail contracts are typically non-exclusive and terminable on relatively short notice by either party. In 2011, Walgreens terminated its contract, only to suffer in sales, and shortly returned. The two companies now collaborate. Pharmaceutical companies use Express Scripts and other PBM companies for access to end-users and therefore seek contracts.

Business Model



Step by Step Walkthrough

1. **A health plan or insurance company negotiates a deal to have Express Scripts handle the prescription plans for the coverage.**
   A. The insurance/health plan benefits from the cheaper prices of the prescriptions that Express Scripts is able to receive, in exchange for an administrative fee

2. **Express Scripts negotiates cheaper prices for prescription drugs both with the pharmaceutical manufacturers and with the retail pharmacies and with the Pharmaceutical manufacturers**.
   B. Manufacturers are willing to provide discounted prescription drugs or rebates because they want to be placed on Express Scripts' formulary, a list of prescriptions that people on the health care plans have access to. The retail pharmacy needs Express Scripts to maintain customers.

3. **A patient pays the health plan a premium, whether it is done through their employer or through self-employment**.
   C. This gives them access to the health plan, which uses Express Scripts. When they get a prescription filled, they provide a co-payment in exchange for their prescriptions. Express Scripts pays the retail pharmacy a dispensing fee, but pays a discounted price for the prescription that was provided.

4. **Express Scripts mails the prescription from its warehouse of prescriptions that were purchased on discount from the pharmaceutical manufacturers.**
   D. For mail-delivery, the retail pharmacy is eliminated, with the co-payment going directly to Express Scripts, thereby increasing profitability.

5. **Express Scripts makes money on the spread between the discounts they receive from the pharmaceutical manufacturers and the discount they provide to the health plan**.
   E. They also pocket the spread between the discounts received from the retail pharmacy and the dispensing fee and the price paid for mail-delivery prescriptions and the negotiated price with the prescription manufacturers. It is apparent that Express Scripts has an important role in every part of the transaction, making them central to the Healthcare industry.

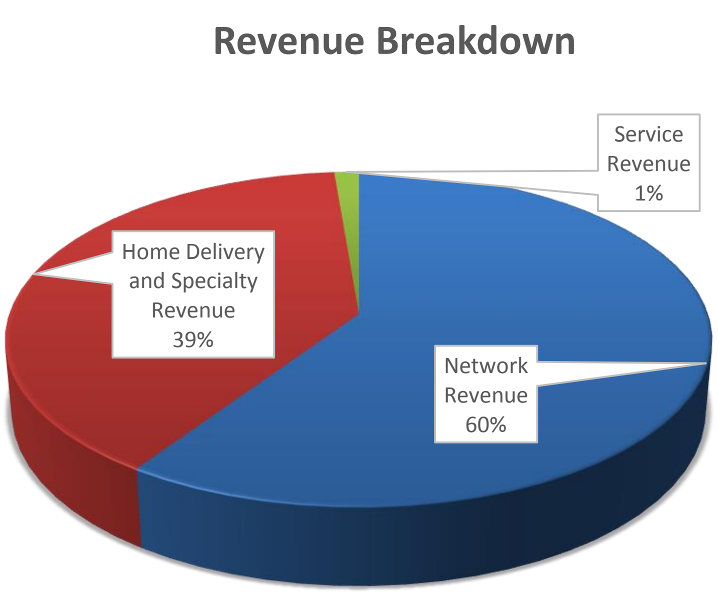
Express Scripts as a 'Middle-Man'

Express Scripts competitive advantages include their size and ability to scale, alignment with clients, and innovation. Currently, the Express Scripts network consists of 90M members, with over 68,000 retail pharmacies that make up 95% of the US pharmacy network. As the middleman of the Healthcare industry, Express Scripts has low margins but profits from extremely high volumes of scripts. Their two main sources of revenue are network services and mail-order services. For network services, the company pockets a spread of approximately 2% for each generic drug discount that it passes along to retail pharmacies. Further, the company has the ability to charge between 10 cents to 35 cents per claim, while it only costs them 8 cents to 13 cents to actually process it. Thus, although the margins are small, Express Scripts benefits from scale and low capital intensity that allows the company to produce approximately $4B every year.

Their Mail-Order Business has been a significant source of revenue. The company owns 6 automated dispensing home pharmacy and 1 non-automated dispensing home pharmacy. The mail order penetration rate is 30%, with the goal for this rate to be 40% as the company grows. Once a customer begins using mail order, they transfer approximately 75% of their scripts. Mail is an excellent opportunity to further customer intimacy and take advantage of the cost savings that Express Scripts can achieve through generic drug discounts.

In December, 2014 Express Scripts proved its control over pharmaceutical companies by excluding Gilead's Hepatitis C treatments, Sovaldi and Harvoni from the national formulary in favor of AbbVie's Viekira Pak. Express Scripts has set a strong precedent that it won't pay for high priced specialty drugs when a clinically equivalent drug is introduced at a lower price or with more significant rebates for Express Scripts. This exemplifies the reach and negotiating power of Express Scripts and how much Express Scripts controls the treatments available to patients.

Revenue Breakdown



Total Revenue ($M): $98,379.6
Network: $58,468.6
Home Delivery and Specialty: $38,633.0
Service: $1,278.0

Revenues were driven in the past by increased volumes of prescriptions. Express Scripts has looked to reduce the cost of goods sold in the future and focus on developing efficiencies and negotiating rebates for its customers, in order to create a larger spread between the revenues and costs. Home Delivery and Specialty Revenue has increased 2.8% in 2014 from 2013 while Network Revenues has decreased 7.6%. The decrease is primarily due to lower claims volume and an increased generic fill rate which increased from 83.7% from 81.6% in 2013. The increase is attributed to an increase in branded dugs.

Valuation and Investment

Please refer to Appendix A for reference to our Excel Models:

Our models have been updated to reflect the most current annual report, which was released in February, 2014.

We calculated Free Cash Flow for 2012, 2013, and 2014. For 2014, the free cash flow is $4,118 billion. Computing historical FCF provides a frame of reference for the current 2014 period. We computed two different models. The first was a typical DCF based on the FCF in the most current period, 2014, using a growth rate of 10%. The growth rate was determined based on a Compound Annual Growth rate of 10%. A WACC of 10% was used based on the historical average Weighted Average Cost of Capital across all industries to be 10% in the last century. However, we acknowledge that the WACC for the Health Care industry to be higher, at approximately 11%, and this is reflected in our sensitivity table.

For the second Discounted Cash Flow Model, we broke out individual projections. Based on changes of the business model, we expect Revenues to decrease by 1% annually. On the other hand, we expect Cost of Goods sold to also decrease by 1% as Express Scripts improves its operational efficiency and moves towards specialty dugs where it has significant negotiating power, home delivery, where Express Scripts is able to cut out the retail pharmacies, and where Express Scripts will continue to gain operational efficiencies from the Medco merger. We estimate that Depreciation will continue historical numbers, as it has remained 2% of revenues for the previous 3 years. This model does not use a FCF growth rate because the cash flows are projected. However, we computed a CAGR of the cash flows to be just over 10%.

In all, we calculate the intrinsic value to be approximately $110.

Investment: 1,716 shares
Date: September 23, 2014
Avg. Price/Share: $76.09
Cost Basis: $123,721.88
Current Mkt Value: 145,654.08
Tot Return (4/7/15): 17.73%
Current Stock Price: $84.88

Model A:

Growth Rate	10%
Terminal Growth	3.5%
WACC	10%
PV of Cash Flows	**$ 88,436.51**
Add: Cash	1,833
Less: Debt	11,013
Equity Value	**$ 79,256.41**
Shares Outstanding	750.3
Intrinsic Value	**$ 105.63**

Model B:

CAGR	10.4%
Terminal Growth	3.5%
WACC	10%
PV of Cash Flows	**$ 98,475.59**
Add: Cash	1,833
Less: Debt	11,013
Equity Value	**$ 89,295.49**
Shares Outstanding	750.3
Intrinsic Value	**$ 119.01**

Looking Ahead

Future plans for Express Scripts are to continuing integrating on the Medco acquisition. This merger had many positive impacts, but its size has given the company some logistical integration challenges that will be faced going forward. In 2014, the company faced many one-time charges and expenses that reduced their earnings, but these are temporary and will dissolve as the company is expected to spend $250M on integration costs this year.

As The Affordable Care Act continues to increase the number of insureds in the market place, Express Scripts will play an increasingly important role in the next few years. Drug costs have been increasingly for several years now, with 2014 being impacted by a new class of drugs that cures Hepatitis C and costs over $80,000. Further, 2015 is expected to follow similar trends as a new cholesterol class of drugs is expected to hit the market later this year.

Appendix A: Discounted Cash Flow Valuation

Free Cash Flow Calculations for 2014 & Free Cash Flow Projections:

FCF Calculation	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Tax Rate:	38.10%	36.40%	36.40%	36.40%	36.40%	36.40%	36.40%	36.40%	36.40%	36.40%
Operating Income	2,794	3,552	3,602	4,565	5,620	6,695	7,791	8,908	10,047	11,207
Add back: equity from voint ventu	15	33	-	-	-	-	-	-	-	-
Add back: deferred taxes	(389)	(574)	(431)	-	-	-	-	-	-	-
EBIT	**2,420**	**3,011**	**3,172**	**4,565**	**5,620**	**6,695**	**7,791**	**8,908**	**10,047**	**11,207**
Less: Taxes	922	1,096	1,155	1,662	2,046	2,437	2,836	3,242	3,657	4,079
Add: Depreciation and Amortizati	1,871	2,447	2,242	2,219	2,242	2,264	2,287	2,310	2,333	2,356
Less: Change in Working Capital		(513)	(295)	120	41	42	43	44	46	47
Minus Capex:	160	423	437	436.6	436.6	436.6	436.6	436.6	436.6	436.6
Free Cash Flow	3,722	4,452	4,118	4,566	5,338	6,043	6,762	7,494	8,240	9,000

Discounted Cash Flow Based on FCF in 2014 and a FCF Growth Rate of 10%:

Period	0	1	2	3	4	5	6	7
Year	2014	2015	2016	2017	2018	2019	2020	TV
CF	4,118	4,530	4,983	5,481	6,029	6,632	7,295	116,164
PV	$ 4,118.01	$4,118.01	$4,118.01	$4,118.01	$4,118.01	$4,118.01	$4,118.01	$59,610.41

Growth Rate	10%
Terminal Growth	3.5%
WACC	10%
PV of Cash Flows	**$88,436.51**
Add: Cash	1,833
Less: Debt	11,013
Equity Value	**$79,256.41**
Shares Outstanding	750.3
Intrinsic Value	**$ 105.63**

Growth	WACC				
	8%	**9%**	**10%**	**11%**	**12%**
8%	143.07	114.80	95.32	81.10	70.28
9%	150.80	120.94	100.36	85.35	73.93
10%	158.87	127.35	**105.63**	89.79	77.74
11%	167.31	134.04	111.13	94.42	81.71
12%	176.11	141.03	116.86	99.25	85.85

Discounted Cash Flow Based on FCF Projections:

Period	0	1	2	3	4	5	6	7
Year	2014	2015	2016	2017	2018	2019	2020	TV
CF	4,118	4,566	5,338	6,043	6,762	7,494	8,240	131,209
PV	$ 4,118.01	$4,151.16	$4,411.96	$4,540.51	$4,618.45	$4,653.22	$4,651.36	$67,330.92

CAGR	10%
Terminal Growth	3.5%
WACC	10%
PV of Cash Flows	**$98,475.59**
Add: Cash	1,833
Less: Debt	11,013
Equity Value	**$89,295.49**
Shares Outstanding	750.3
Intrinsic Value	**$ 119.01**

Growth	WACC				
	8%	**9%**	**10%**	**11%**	**12%**
10%	179.11	143.53	**119.01**	101.14	87.54