GreensKeeper
ASSET MANAGEMENT INC.

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# Investment Memo – April 2, 2018

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Founder and Chief Investment Officer

## Express Scripts Holding Company (Nasdaq:ESRX)

**Recommendation:** Long Express Scripts
**Current Stock Price:** $69.08 (as of 03/30/2018)
**Target Price:** $89.58 (30% upside)
**Timing:** < 12 months
**Catalysts:** Closing of announced M&A transaction; Deal spread reduction

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### Investment Summary

On March 8, 2018, health insurer **Cigna Corporation** (NYSE:CI) announced that it had entered into an agreement to acquire pharmacy benefit manager **Express Scripts Holding Company** (NASDAQ: ESRX) in a $67 billion stock and cash transaction. Financing for the transaction has been committed and the transaction is expected to close by year end. At current prices, the deal spread has widened to approximately 30% and Express Scripts trades below where it did prior to the deal announcement. Express Scripts also trades at a modest discount to our fundamental valuation for the company on a standalone basis.

There are two main risks that would prevent the transaction from closing. First, shareholder approval of both companies is required. Second, the transaction is subject to Hart-Scott-Rodino and state regulatory approvals. We assign a conservative 50% probability to the transaction completion and view the risk-reward of a long position in Express Scripts to be favourable at current prices given the modest downside. If the transaction closes by year end (management's expectation), the annualized return is 39.5%. As a long-only fund, this is not a merger arb (long/short) call. **Disclosure: The GreensKeeper Value Fund and certain accounts managed by us are currently long Express Scripts and certain other stocks mentioned in this memo.**

| | Company | Ticker | Share Price |
|---|---|---|---|
| Acquiror | Cigna Corporation | NYSE:CI | $167.74 |
| Target | Express Scripts Holding Company | Nasdaq:ESRX | $69.08 |
| | | | |
| | Exchange Ratio | 0.2434 | |
| | Cash Portion | $48.75 | |
| | Spread | $20.50 | |
| | Today's Date | 1-Apr-18 | |
| | Targeted Closing Date | 31-Dec-18 | |
| | Time to Close (Days) | 274 | |
| | Return | 29.7% | |
| | Annualized Return | 39.5% | |

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**Transaction Overview**

On March 8, 2018, **Cigna Corporation** (NYSE:CI) announced that it had entered into an agreement to acquire **Express Scripts** Holding Company (NASDAQ: ESRX) in a $67 billion stock and cash transaction. On closing, shareholders of Express Scripts will receive $48.75 in cash and 0.2434 shares of Cigna for each share of ESRX that they currently hold.

The proposed transaction is a vertical merger as there is very little overlap in the business of each company. Cigna is the fifth-largest health insurer in the United States (by revenue). Express Scripts is the largest independent pharmacy benefit manager (PBM) in the United States. PBMs aggregate the buying power of many healthcare payers (including health insurers) and use that scale to negotiate favourable pricing from drug manufacturers. A negotiated portion of the savings is passed along to the client and a portion retained by the PBM.

Cigna Corporation NYSE:CI

| Capitalization | | Financials (2018E) | | Valuation | |
|---|---|---|---|---|---|
| Share Price | $167.74 | Revenue | $44,055 | EV/Revenue | 0.98 |
| Market Cap | $40,801 | EBITDA | $4,984 | EV/EBITDA | 8.69 |
| Net Debt | $2,268 | Net Income (ex-items) | $3,128 | P/E | 13.85 |
| Enterprise Value | $43,317 | FCF | $3,536 | P/FCF | 11.54 |

Express Scripts Holding Company Nasdaq:ESRX

| Capitalization | | Financials (2018E) | | Valuation | |
|---|---|---|---|---|---|
| Share Price | $69.08 | Revenue | $100,979 | EV/Revenue | 0.52 |
| Market Cap | $38,770 | EBITDA | $7,697 | EV/EBITDA | 6.82 |
| Net Debt | $13,705 | Net Income (ex-items) | $5,335 | P/E | 9.84 |
| Enterprise Value | $52,475 | FCF | $5,432 | P/FCF | 7.14 |

*Source: Capital IQ as of 04/01/2018. 2018E reflects analyst consensus estimates.*

Cigna management provided several reasons supporting the strategic rationale for the transaction: better customer experience, a broader/integrated offering; scale; personalization; cost savings / synergies of $600 million; etc. These are only relevant to our investment thesis insofar as they relate to the likelihood of the transaction closing.

Financing for the transaction has been committed (Morgan Stanley Senior Funding, Inc. and The Bank of Tokyo-Mitsubishi UFJ, Ltd). Our review of the Merger Agreement filed with the Securities and Exchange Commission (SEC) suggests that there are only two material risks that would prevent the Merger from closing which are discussed in detail below. The remaining conditions appear to be standard in transactions of this nature and should be fulfilled in due course.

**Material Risk #1: Shareholder Approvals**

The shareholders of each of Cigna and Express Scripts are required to approve the adoption of the Merger Agreement. Given the healthy 30% premium being paid to Express Scripts shareholders and the favourable recommendation of its board, we view approval by the Express Scripts shareholders to be a non-issue. However, the approval of the transaction by the Cigna shareholders is less certain.

Cigna's stock has declined from $194.25 pre-announcement to $167.74 or down 13.6% (versus the S&P500 which was down 3.2% over that three-week time period). While it is often the case that the acquirer's share price declines in a major M&A transaction (especially one involving share consideration due to merger arbitrage), the magnitude of the selloff suggests that there is some level of disapproval of the transaction within the Cigna shareholder base.

Cigna requires that a simple majority (50% of the votes cast) vote in favour of the transaction. Cigna's board of directors has approved the transaction and, subject to certain conditions, will recommend to its shareholders to approve the transaction. They have received a fairness opinion from their financial advisor – Morgan Stanley. Cigna management wants the transaction to close and will likely take the necessary steps to obtain shareholder approvals (e.g. retaining a proxy solicitation firm).

Our review of the publicly available information on Cigna's shareholders, suggests that the stock is widely held with the largest holders being passive. There do not appear to be any major activist investors involved at this point, however that can change quickly. We assume that merger arb shareholders (e.g. long Express Scripts, short Cigna) will vote their shares in favour of the transaction.

| Top Holders - CI | | | |
|---|---|---|---|
| T. Rowe Price Group, Inc. | 17,756,569 | 7.30% | Dec-31-2017 |
| The Vanguard Group, Inc. | 17,289,066 | 7.11% | Dec-31-2017 |
| BlackRock, Inc. | 17,155,180 | 7.05% | Dec-31-2017 |
| Dodge & Cox | 10,734,593 | 4.41% | Dec-31-2017 |
| State Street Global Advisors, Inc. | 10,402,243 | 4.28% | Dec-31-2017 |
| | 73,337,651 | 30.15% | |
| | | | |
| Activists | | 0.61% | |

Source: Capital IQ, GreensKeeper.

**Material Risk #2: Regulatory Approvals**

Given the transaction's size, it is subject to a Hart-Scott-Rodino (HSR) merger review. Once the HSR pre-merger notification filings are made by both Cigna and Express Scripts, either the Department of Justice (DOJ) or the Federal Trade Commission (TFC) will assume carriage.

The transaction review is complicated by several related developments. On December 3, 2017, **CVS Health** (NYSE:CVS) announced that it was acquiring **Aetna** (NYSE:AET) in a $69 billion cash and stock transaction. CVS is a large pharmacy retailer but also owns a major PBM (Caremark). Aetna, like Cigna, is a major US health insurer. Given the similarities between the two transactions and the overall industry consolidation, our view is that it increases the regulatory risks involved in both transactions. Second, the Trump Administration has made several statements relating to drug price reduction and has made policy moves that impact health insurers. Rising healthcare costs is a highly politicized topic and we are in a mid-term election year. Regulators will need to be seen to be scrutinizing the proposed transaction which also heightens the risks involved.

Historically, vertical mergers such as the one proposed by Cigna and Express Scripts were most likely to be approved. That may no longer be the case in light of the DOJ's current attempt to block the vertical merger of **AT&T** (NYSE:T) and **Time Warner** (NYSE:TWX).

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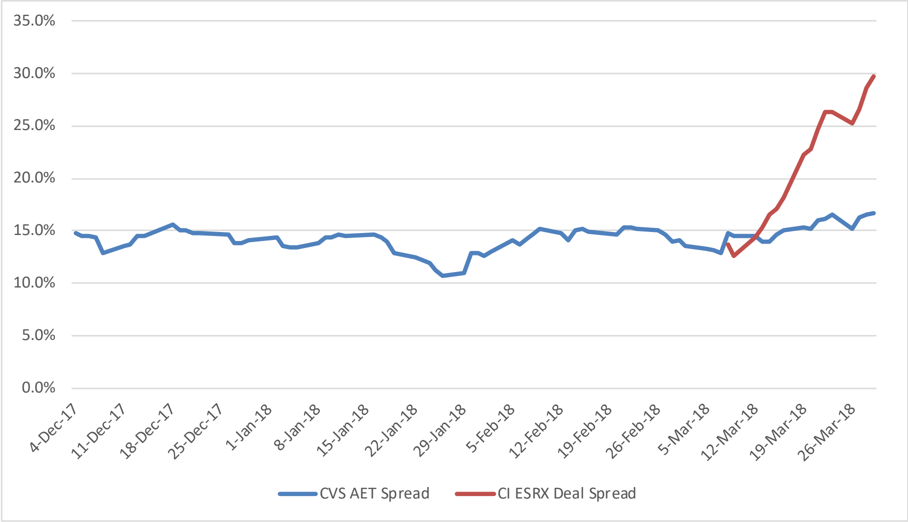
The DOJ has assumed carriage of the proposed CVS/Aetna transaction and on February 1, 2018, issued a "second request" letter to each merger partner. We assume that the DOJ will also assume carriage of the proposed Cigna/Express Scripts transaction review and that they will also issue a "second request" letter to the participants.

**Risk Assessment**

There are two primary outcomes possible – the transaction closes or it does not due to: (i) a failed Cigna shareholder vote or (ii) regulatory opposition to the transaction that cannot be remedied by structural concessions. There is also the remote possibility that another superior proposal materializes for Express Scripts. We will ignore that scenario given its low probability and the fact that it would be a positive surprise. Another outlier is the risk that the Trump Administration takes action to target PBMs who have been the subject of a number of negative articles in the past few years.

In light of all the foregoing, we assess the overall probability of the transaction closing at approximately 50%. This figure is more conservative than some analysts that view regulatory signoff as "highly probable".(1) Cigna management believes that the transaction will close by year end. In light of the regulatory environment, we have assumed that the transaction closes in one year which reduces the annualized return on a successful completion to 30% upside (down from 39.5%).

We see no reason why the proposed Cigna/Express Scripts transaction would be more likely to be rejected than the proposed CVS/Aetna transaction. In addition, the largest health insurer in the US - **UnitedHealth Group** (NYSE:UNH) – is already vertically integrated via its PBM subsidiary OptimumRx. Another major health insurer - **Anthem, Inc.** (NYSE:ANTM) - is currently starting its own PBM internally.(2) Additional vertical integration, in an attempt to rein in rising healthcare costs, seems like a reasonable experiment that shouldn't be blocked on policy grounds (but could be for political reasons). The deal spread on both pending transactions was similar for a short time but the Cigna/Express Scripts spread has dramatically widened over the past three weeks. We are puzzled by the current spread and unable to come up with a convincing argument for why it should continue to exist.




Source: Capital IQ, GreensKeeper.

*(1) Credit Suisse analyst Erin Wilson; Source: Bloomberg 3/29/2018. In a published note on Cigna dated 3/12/2018, another Credit Suisse healthcare analyst placed a 70% probability on the deal getting approved.*
*(2) Anthem to Launch Its Own Pharmacy-Benefit Manager. The Wall Street Journal 10/18/2017 by A. Wilde Mathews.*

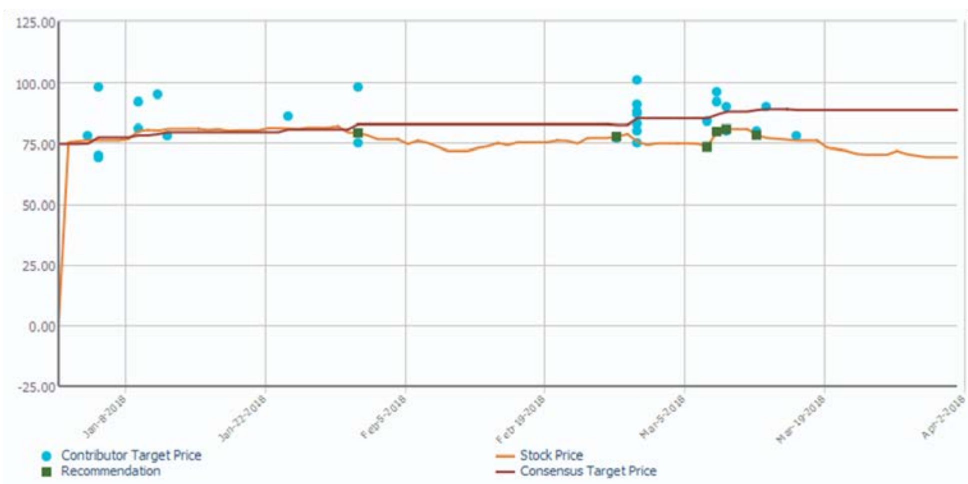
**Outcomes and Expected Values**

If the transaction closes, the deal spread will disappear and we expect a return of approximately 29.7% or an annualized return of 29.7% to 39.5% depending on the timing of the closing. We also retain the option of selling Express Scripts in the interim if the gap closes sufficiently. As the transaction consideration is based on a fixed exchange ratio, we bear the risk of further declines in Cigna's stock impacting the overall consideration to be received, potentially lowering our return.

In the event that the transaction does not close, we will be long Express Scripts and assume the risk that the stock sells off. There are several reasons that we believe that the downside is limited in this scenario.

First, depending on the reason for the transaction being aborted, Express Scripts stands to be paid a break fee of between $1.6 and $2.1 billion. This represents $2.30 to $3.00 per ESRX share fully-taxed. Obviously there will be some offsetting legal and advisory costs. Second, we believe that at the current price of $69.08, the shares of Express Scripts are trading slightly below their intrinsic value based on a fundamental analysis.

Prior to the transaction announcement, Express Scripts was trading at an undisturbed price of $73.42 per share (or 5.9% higher than current levels with the market down only 3.2% during that same period). Analyst target prices pre-announcement ranged from a low of $69.00 to a high of $100.00.(3)




Source: Capital IQ

We have also owned Express Scripts in the past and are familiar with the company and its industry. Our prior newsletters detailing the company and our investment thesis at the time can be found at the following links: Scorecard #10 – September 2014 and Scorecard #13 – January 2016. Since the time of our prior ownership of the stock, the company has grown its earnings and two major events have transpired, one positive and one negative.

The US tax reform enacted in December 2017 is a large positive for the company. Express Scripts' business is conducted almost entirely in the US and historically the company has had an effective tax rate of approximately 35%. The reduction to a lower corporate rate will reduce the company's tax expense by approximately $850 million per year or $1.55 per share.

*(3) As a former securities lawyer and former investment banker, the author gives little weight to fairness opinions and analyst targets. We strongly urge readers to do the same and to do your own work.*

On the negative side, Express Scripts is defending itself in litigation with its largest client – health insurer **Anthem, Inc.** (NYSE:ANTM). Anthem is claiming billions of dollars in damages for breach of contract, Express Scripts is vigorously defending the claim. In addition, Anthem has given notice to Express Scripts that they do not intend to renew their PBM contract with the company upon its end date in 2019. As a result, we believe the proper way to value Express Scripts is to value the company's core business (ex-Anthem). Express Scripts has now started to provide the market with a breakdown of its financial results on this basis.

For 2018, management is guiding to normalized EPS of $9.27 - $9.47 and the company has a good track record of delivering on its guidance targets. Earnings adjustments exclude the amortization of intangible assets related to historical acquisitions. We view the adjustments as appropriate and the normalized EPS as a close proxy of what Warren Buffett refers to as Owner Earnings.

At the earnings guidance midpoint, the stock is trading at 7.4x earnings at present. Express Scripts is a low capex business and free cash flow is expected to exceed earnings in 2018. We estimate that the stock is trading at about 7.0x 2018E free cash flow. However, these multiples include contributions from the Anthem runoff business. Stripping that out, our analysis suggests that the core business will generate earnings of about $6.00 per share in 2018 with another $3.37 per share coming from the runoff business. In other words, at the current share price, Express Scripts is trading at 11.6x core EPS.

| | | 2018 Guidance Range (Core) | | 2018 Guidance Range (ANTM, Coventry and Cat.) (roll-off) | | 2018 Guidance Range Total | |
|---|---|---|---|---|---|---|---|
| Adj. Claims (millions) | | 1,125 | 1,165 | 220 | 230 | 1,345 | 1,395 |
| Adj. EBITDA/ Claim | | $4.51 | $4.80 | $10.22 | $10.91 | $5.45 | $5.80 |
| EBITDA | | $5,250 | $5,400 | $2,350 | $2,400 | $7,600 | $7,800 |
| | | | | | | | |
| less Capex | | $490 | $540 | $0 | $0 | $490 | $540 |
| EBIT | | $4,760 | $4,860 | $2,350 | $2,400 | $7,110 | $7,260 |
| Interest Exp. (net) | | $600 | $600 | | | $600 | $600 |
| EBT | | $4,160 | $4,260 | $2,350 | $2,400 | $6,510 | $6,660 |
| T | | $915 | $937 | $517 | $528 | $1,432 | $1,465 |
| Net Income | | $3,245 | $3,323 | $1,833 | $1,872 | $5,078 | $5,195 |
| Weighted Avg. Diluted Shares Out. | | 550 | 550 | 550 | 550 | 550 | 550 |
| Owner EPS | | $5.90 | $6.04 | $3.33 | $3.40 | $9.23 | $9.45 |
| | | | | | | | |
| EPS per company guidance | | | | | | $9.27 | $9.47 |
| | | | | | | | |
| CFO per company guidance | | | | | | $5,775 | $6,275 |
| CFO per company guidance | | | | | | $520 | $628 |
| FCF | | | | | | $5,255 | $5,648 |
| FCF Per Share | | | | | | $9.56 | $10.27 |
| | | | | | | | |
| P/E (2018E) | 7.4 | | | | | | |
| P/E (2018E - core only) | 11.6 | | | | | | |
| P/FCF (2018E) | 7.0 | | | | | | |

*Source: Company management, SEC filings, GreensKeeper estimates.*

The company's revenue has been flat for the past few years and earnings growth has come largely from gross margin improvement, cost cutting and substantial share repurchases. Management expects core EBITDA to grow going forward and is guiding to 8% core EBITDA growth in 2018. The company may not deserve a growth multiple but we would argue that at 11.6x current year earnings (ignoring close to $6.70 in earnings in 2018 and 2019 from the runoff business plus another $2.30 to $3.00 per share from break fees), the downside to a failed M&A transaction should be limited.

Share repurchases and debt repayments are on hold pending the closing of the Cigna transaction. If the transaction is aborted, Express Scripts' cash balance will build in the interim and can then be used in the future for those purposes. The company is committed to maintaining its investment grade credit rating (currently BBB+ – S&P; Baa2 – Moody's) post-Anthem and is allocating a portion of its free cash flow to debt retirement in the next few years.

**Conclusion**

At current prices, the deal spread has widened to approximately 30% and Express Scripts trades below where it did prior to the deal announcement and at a modest discount to our fundamental valuation for the company on a standalone basis.

The two main risks that would prevent the transaction from closing are known. First, shareholder approval of both companies is required. Second, the transaction is subject to Hart-Scott-Rodino and state regulatory approvals. We assign a conservative 50% probability to the transaction completion and view the risk-reward of a long position in Express Scripts to be favourable at current prices given the modest downside. As a long-only fund, this is not a merger arb (long/short) call.

Even if our assessment of the probability of a successful conclusion is high, an investment in Express Scripts may still be attractive given the asymmetric risk/reward. We view the magnitude of a positive outcome to be significantly higher than the magnitude of a potential loss. In the event that the deal closes by year end (management's expectation), the annualized return is 39.5%. We also retain the optionality to close out the position if the deal spread shrinks in the interim.

**Disclosure: The GreensKeeper Value Fund and certain accounts managed by us currently own shares in Express Scripts, Anthem and AT&T.**



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**Regulatory Disclosures:**

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