Rebates Rattle the Pharmaceutical Supply Chain

But potential changes appear unlikely to significantly stress credit profiles in the sector.

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Contents

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Executive Summary

In the controversy surrounding U.S. pharmaceutical pricing inflation, rebates have come under fire. Within the supply chain, pharmaceutical firms, pharmacy benefit managers, and insurers all appear to be pointing fingers at one another as the source of the rebate problem. However, from a credit perspective, we believe it really doesn't matter who the culprit is, and ultimately, changing the rebating practice looks unlikely to move the needle on any of our credits in the pharmaceutical supply chain.

Key Takeaways

- Most parties in the pharmaceutical supply chain appear to benefit somewhat from the current rebating system, which has resulted in gross list prices rising at a much higher pace than net prices in recent years.
- Regulators have highlighted the elimination of rebates as a way to protect consumers in the pharmaceutical marketplace since patients' out-of-pocket expenses are influenced by the list, rather than net, price of each therapy.
- Despite this potential change, the elimination of rebates appears manageable in the pharmaceutical supply chain, even for the pharmacy benefit managers that appear to be shouldering most of the blame for rebating by regulators. Also, with the current consolidation planned in the PBM sector, the direct influence of rebates on profits looks likely to continue falling for PBMs, given their diversifying revenue streams.

Companies Mentioned

Name (Ticker)	Rating	Outlook/UR	Coupon	Maturity	Price	Yield	Spread
AmerisourceBergen Corp (ABC)	A	Stable	3.45%	12/15/2027	93.71	4.28%	+136
Cardinal Health Inc (CAH)	A-	Stable	3.41%	06/15/2027	92.18	4.50%	+158
McKesson Corp (MCK)	A-	Stable	3.95%	02/16/2028	96.72	4.38%	+145
UnitedHealth Group (UNH)	A-	Stable	3.85%	06/15/2028	100.98	3.73%	+80
Express Scripts Holding Co (ESRX)	A-	UR-	3.40%	03/01/2027	93.28	4.36%	+145
CVS Health Corp (CVS)	BBB+	UR-	4.30%	03/25/2028	99.78	4.33%	+140
Walgreens Boots Alliance Inc (WBA)	BBB	Stable	3.45%	06/01/2026	94.85	4.24%	+134
Cigna Corp (CI)	BBB	UR-	4.38%	10/15/2028	100.00	4.38%	+152

Source: Interactive Data, as of Sept. 6, 2018

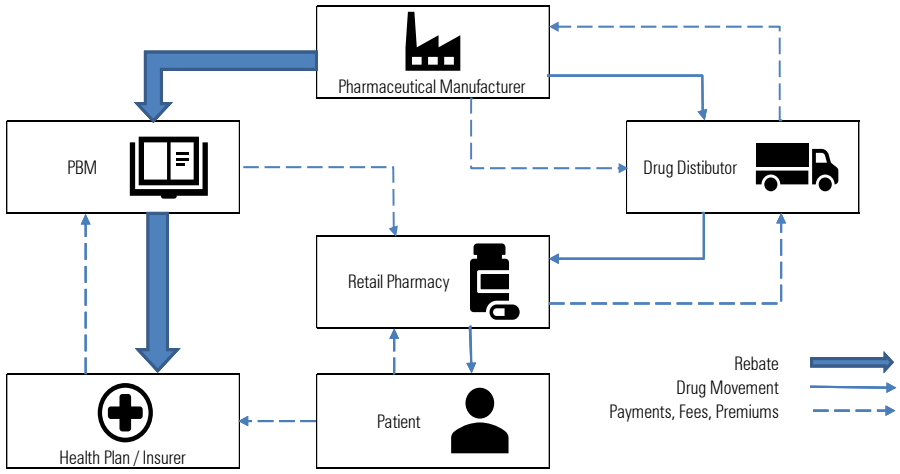
The Rebate Value Chain

What Is a Pharmaceutical Rebate?

Pharmaceutical firms offer rebates, or partial refunds, on the gross list price of their products to third-party payers, such as insurers or large employers. For those buyers, manufacturers realize a lower net price than the gross list price. PBMs negotiate these rebates on behalf of their clients, and the lower realized price can affect how a therapy is placed on the PBM's formulary and ultimately how patients utilize the therapy.

Exhibit 1 shows the general flow of products and dollars in the pharmaceutical supply chain.

Exhibit 1 Pharmaceutical Supply Chain Flows



Source: Morningstar Credit Ratings, LLC

Who Benefits From Rebates Today?

- *Third-party payers*. These payers—such as insurers, government agencies, and large employers—ultimately receive the rebates from pharmaceutical manufacturers, so those payers directly benefit from rebates. These payers can choose whether to pass on the savings to their insured patient populations or not. For example, in an attempt to reduce the backlash about not sharing rebates directly with patients, UnitedHealth Group Inc (non-NRSRO rating: A-, stable) announced in March that it would start directly sharing rebates on specific drugs with patients taking those therapies. Previously, UnitedHealth attempted to pass those savings indirectly to its entire insured patient population through lower insurance premiums. Critics viewed that process as lacking transparency. However, to offset this rebating practice change, premiums need to rise somewhat for its broader constituency.
- *Pharmaceutical firms.* Manufacturers give rebates to third-party payers, especially in competitive therapeutic markets, to get an advantageous spot for their brand-name medicines on a PBM's formulary. In markets where several therapies have similar safety and efficacy profiles, PBMs ultimately should favor lower-priced therapeutics; rebates are a tool PBMs use to reduce the net prices realized for their

clients. A lower-priced therapy typically would have a more advantageous place on a PBM's formulary—and greater utilization—than a higher-priced therapy, all else being equal.

- *PBMs.* Pharmacy benefit managers, such as CVS Health Corp (BBB+/UR-), Express Scripts Holdings Co (A-/UR-), and UnitedHealth's OptumRx group, negotiate the rebates and can also receive a portion of those rebates as incentive for negotiating lower prices for their clients. PBMs claim that their clients, the third-party payers, determine how much of the rebate the PBMs keep. The PBMs have noted in the past that some of their clients keep all of the rebate for themselves while other clients think the PBMs will work harder to reduce their realized pharmaceutical costs if the PBMs keep some of the rebate. Generally, the PBMs have described the rebate distribution as a customer choice that they are ambivalent about in the long run.

Who Is Hurt by the Rebating Practice?

Patients, whether they are insured or uninsured, primarily have been hurt the most in the existing rebating system. Insured patients' copayments, coinsurance, or deductible payments are determined by the gross list price, so as gross prices increase, patients' out-of-pocket expenses can also rise. Notably, though, with the rise of couponing from pharmaceutical firms and other factors, the final out-of-pocket expense for patients really hasn't changed much from around $30 on average per prescription during the past five years, according to the IQVIA Institute.

Uninsured patients really feel the disparity between gross and list prices, though. According to the IQVIA Institute, "Discounts, rebates, and other price concessions on brands reduced absolute invoice spending by an estimated 28% to $324.4 billion" on pharmaceutical products on a net basis in 2017. So uninsured patients not only have to pay for the entire cost of the drug rather than a more nominal copayment or deductible payment that insured patients must pay, but uninsured patients also are charged about 28% more on average for their therapies than a third-party payer would be charged. Gross list prices have also grown at a higher rate than net realized prices. For example, in 2017, CVS highlighted that it held drug price growth to just 0.2% for its PBM clients versus gross list prices increasing 9.2% on traditional brands and 8.3% on specialty brands. Express Scripts recently highlighted that drug prices grew only 1.5% for its commercial plan clients in 2017 and 1.1% in the first half of 2018, which was a record-low trend for the PBM.

Regulators have recently identified rebates as one of the problems with pharmaceutical price inflation that it can potentially fix. In May, the White House released a policy paper, "American Patients First: The Trump Administration Blueprint to Lower Drug Prices and Reduce Out-of-Pocket Costs," which touches on the possibility of reinvestigating drug rebating, so patients using government assistance would be less hurt by copayments linked to rising list costs of medicines. A proposal in July from the Department of Health and Human Services, "Removal of Safe Harbor Protection for Rebates to Plans or PBMs Involving Prescription Pharmaceuticals and Creation of New Safe Harbor Protection," more specifically looks at rebating in the drug industry. While details of the proposal are not clear at this time, the guideline has already been submitted for review to the Office of Management and Budget, which is tasked to determine the economic impact of the proposal.

What Could Happen If Rebating Stops?

- *Pharmaceutical firms.* We believe the rapidly growing spread between list and net prices is unsustainable, as it distorts fundamentals of a free market for brand-name pharmaceutical manufacturers. Ultimately, however, changing the gross list price to the realized net price should have little, if any, effect on the profitability of these firms. Over the past few months, rebates have drawn only general commentary from executives in the branded drug industry, given the current vagueness and uncertainty of timing of the Trump administration's intentions. However, legitimate concerns surround the likelihood that any framework established by the government for pricing initially within the Medicare program may bleed into the commercial marketplace, where higher profitability resides. Nonetheless, the pharmaceutical industry has already embraced new mechanisms that may address increasing drug costs, including value-based pricing, which are being used (albeit sparingly) during contract negotiations with third-party payers. A shift to up-front discounting, which would virtually eliminate the gross to net spread rather than after-sale rebating for formulary positioning, could still be accomplished within the present structure of the drug supply chain. We assert that innovation remains the key driver of industry growth and should be rewarded with greater profitability, which may keep earnings relatively steady during any transition in third-party contracting to more immediate price concessions.
- *Pharmacy benefit managers.* While taking away one negotiating tool to lower prices—rebates—could reduce PBM efficacy somewhat, we still think PBMs will play a vital role in keeping U.S. pharmaceutical price inflation in check for their clients. Outside the United States, pharmaceutical pricing and utilization are typically regulated by government agencies, especially in countries that provide universal health insurance. In contrast, the U.S. healthcare system is relatively free from government regulation in terms of pricing and utilization. In this environment, U.S. payers have used PBM services to help keep pharmaceutical prices at reasonable levels. Unless the U.S. regulatory environment changes substantially, we do not believe demand for PBM services will decline dramatically even if rebates are eliminated, as PBMs are in the best position to keep pharmaceutical prices in check through other means.

Also, the direct impact of rebates appears manageable for PBMs. For example, CVS announced in August that rebates accounted for only about 3% of its earnings power, which appears easily manageable if rebates are eliminated. Similarly, Express Scripts revealed in August that about half of its clients elect to keep all rebates, and it returns 95% of all pharmaceutical purchase discounts, price reductions, and rebates to its clients. In our opinion, 5% of annualized pharmaceutical prices does not appear to be a huge cost for third-party payers hoping to constrain pharmaceutical pricing and utilization in the long run. Express Scripts also highlighted that all collected Medicare Part D rebates are passed through to the government and insurance beneficiaries, so eliminating those rebates would not affect its earnings power.

Importantly, the PBM and health insurance industries look set to become even more intertwined in the near future, as mergers between Express Scripts and Cigna Corp (non-NRSRO rating: BBB/UR-) along with CVS and Aetna Inc (not rated) are planned for around the end of 2018, pending regulatory approval. The other top-tier PBM, OptumRx, already operates within an insurer, UnitedHealth. Therefore, the business of managing pharmacy benefits looks likely to become even less transparent to investors soon,

as top-tier PBMs get tucked away into larger, more diverse operations within the healthcare industry. Exhibit 2 shows that the planned Express Scripts-Cigna combination will remain the most exposed to PBM services from a profit mix perspective. We estimate that PBM services will still represent at least half of profits for Cigna-Express Scripts even after Express Scripts loses the Anthem contract in late 2019. Cigna also provides some PBM services that it does not fully disclose, so they are not incorporated in Exhibit 2. We estimate CVS' PBM business will represent about one third of the combined CVS-Aetna profits. UnitedHealth looks the least exposed to the PBM business with only about one fifth of its profits coming from those services.

Exhibit 2 PBM Business Mix

	Segment Operating Profits (2017)						
$s in Millions	CVS	AET	CVS/AET	ESRX	CI	ESRX/CI	UNH
PBM	$4,755	na	$4,755	$5,407	na	$5,407	$3,118
ex Anthem contract	na	na	na	$3,605	na	$3,605	na
Other	$6,469	$3,843	$10,312	$87	$3,606	$3,606	$12,091
Total	$11,224	$3,843	$15,067	$5,494	$3,606	$9,013	$15,209
PBM as % of Total	42%	na	32%	98%	na	60%	21%
ex Anthem contract	na	na	na	na	na	50%	na

Source: Company reports and Morningstar Credit Ratings, LLC

Distributors. The top distributors—AmerisourceBergen Corp (A, stable), Cardinal Health Inc (A-, stable), and McKesson Corp (A-, stable)—can be influenced by pharmaceutical price inflation or deflation between the time they purchase a therapy and the time they sell the product to retailers such as Walgreens Boots Alliance Inc (BBB, stable). If rebates are eliminated, distributors may face a tough, albeit short, interim period. However, on recent investor calls, management teams from the top distributors noted two factors that should mitigate the potential threat of manufacturers lowering prices to the net rather than list price. First, about 15 years ago, distributors started moving their businesses to fee-for-service models rather than being contingent primarily on price inflation. The top three distributors recently all discussed how only about 10% of their branded distribution businesses relate directly to price inflation, so roughly 90% of the branded businesses of the top distributors are based on fixed fees for service. While major pricing cuts from gross list to net realized pricing could hurt the distributors somewhat, we believe they can manage that cut in the longer term. Second, the management teams from each distributor noted that their manufacturer partners recognize the value brought to the pharmaceutical marketplace by distributors, and they would expect to be able to negotiate for higher rates in inflation-contingent contracts if the branded pricing environment changes substantially. While uncertainty surrounds any contractual renegotiation, we suspect that AmerisourceBergen, Cardinal, and McKesson, which all enjoy wide moat assessments from Morningstar's Equity Research Group, have enough power in the pharmaceutical supply chain to receive a fair value for the services they provide to their manufacturer clients in the long run. Therefore, we would not expect potential rebate changes to significantly affect the credit profiles of the distributors.

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