What are PBMs worth?

by
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In light of Caremark's recent $6 billion bid for AdvancePCS, it seems appropriate to take a brief look at the pharmacy benefit management industry and see whether the purchase price is justified. The merger, if approved, would narrow the field to three key players: Medco, Express Scripts, and the newly formed Caremark/AdvancePCS entity, which will retain the Caremark name.

In 1999, the pharmaceutical manufacturers Eli Lilly and SmithKline Beecham both decided to divest themselves of their subsidiary PBMs, PCS and Diversified Pharmaceutical Services (DPS), respectively. Lilly had paid $4 billion to acquire PCS from McKesson in 1994 and in 1999 sold it to Rite Aid for $1.5 billion. Around the same time SmithKline Beecham sold DPS to Express Scripts for $700 million, about one-third of the $2.1 billion purchase price paid to United Healthcare in May of 1994.

Less than two years after Rite Aid acquired PCS from Lilly, the PBM was again on the block. Rite Aid sold PCS to Advance Paradigm, a smaller PBM, for just under $1 billion, taking a $600 million loss.

So what, if anything, has happened in the PBM industry since 2001 to cause this "turnaround" and justify the $6 billion price tag Caremark is now paying for AdvancePCS?

Numerous articles, dating back to the mid-90s, question the value and sustainability of the PBM concept. And the reasons for questioning the value of the PBM business model haven't changed much in the past 10 years.

One of the newer concerns about these organizations is how revenue is reported. The combined Caremark/AdvancePCS entity is projected to have more than $23 billion in revenue. What's important to understand is that well over 95% of this revenue figure is simply money that passes through the organization. The PBM is merely a conduit from the health plan, paying for the drugs to the pharmacy.

AdvancePCS recently signed a three-year extension of services with Health Net Inc., stating that, under the conditions of this new agreement, it would no longer include the drug spend—the funds Health Net pays for prescriptions—in revenue for this client. AdvancePCS acknowledged that this would lower revenue by $1.3 billion starting in fiscal 2005 but was quick to point out that it would not affect the company's gross profit, net income, and general or administrative expenses.

What seems quite logical is that if a $1.3 billion reduction in revenue would have no impact on profit, using the same accounting methodology, a $1.3 billion increase in the same type of revenue would not have any impact on the company's profits either.

This method of reporting revenue is another reason entering the specialty pharmacy market has been so attractive to the PBMs, as it can have a major positive influence on reported annual revenue figures. The typical specialty prescription can be five to 40 times the cost of a prescription for an oral medication filled at the corner drugstore. Again, this money, while simply passing through the PBM, contributes a great deal to the organization's stated revenue.

But back to the question of what has changed to make AdvancePCS worth $6 billion. Unless there is a very well kept secret in the industry, PBMs haven't really made any significant changes in the methods used to maintain profitability. Primarily, they thrive on:

- The spread between what they charge employers and healthcare organizations for prescription drugs and what they pay their network pharmacies
- Claims processing fees
- Profits from the sale and distribution of drug products from specialty and mail-order distribution centers
- Profits from retaining all or a portion of the rebates recovered from drug manufacturers for products used by their clients
- Charges for additional administrative activities, performing P&T functions, and customized reporting
- Profits from the performance of utilization management programs (e.g., prior authorization and therapeutic switch programs)

These are the same basic products and services that have always supported the PBM industry. Unfortunately for the PBMs, as health plans become more sophisticated in their understanding of their industry and their contracting strategies, each of the areas highlighted is producing smaller margins, while, as mentioned earlier, having little or no effect on revenue.

Providing utilization

VIEWPOINT (cont.)

management programs has become a focus of the PBMs and is their hope for the future. However, these are extremely resource-intensive programs, requiring highly skilled and highly paid professional staff for implementation and maintenance. There is currently a reluctance in the healthcare marketplace to use and pay for these programs.

Granted, the PBMs are pursuing other opportunities to generate profits by entering into agreements for services with several other organizations, but this has resulted in both federal and state government investigations into certain PBM business practices.

What arguably has changed in the recent past is the general perception within the healthcare industry that PBMs are a necessary component of providing a comprehensive pharmacy benefit package. More and more health insurance companies, healthcare organizations, and employers are realizing that assuming the administrative and operational responsibility for providing a pharmacy benefit, if done properly, is not as difficult as previously thought.

Healthcare organizations can choose the limited services they need from PBMs, while maintaining much tighter control and authority internally for their pharmacy benefit. There are several organizations that will provide health plans with guidance and assist them in obtaining the services necessary for insourcing while getting the best possible product and service pricing from the pharmacy network and the pharmaceutical industry. Basically, the health plan can squeeze out a sizable portion of what they are paying the PBM, while performing these services and simultaneously contributing directly to their own bottom line.

While the opportunities for PBMs to generate profits are growing, the margins available on those services seem to be getting leaner. This makes it difficult to fathom a $6 billion price tag for AdvancePCS, when only three years ago the combined value of the two companies was less than $2 billion.

In the past, some very large, very smart organizations paid top dollar for these PBM companies only to suffer heavy losses when divesting. If Caremark is positioning itself for the upcoming Medicare battle, the merger might be the right move, but if the legislation goes nowhere, it could be a costly investment for the shareholders of both companies.

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