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VIEW FROM THE BUYSIDE

Buyout Target Express Scripts Has 30%-Plus Upside

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• Recent price: $67.87

• Target price: $89.58

• Timeframe: 6-12 months

The Opportunity:
On March 8, 2018, health insurer Cigna Corp oration (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.

Two Material Risks
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 favorable at current prices given the modest downside. If the transaction closes by yearend (management's expectation), the annualized return is 39.5%. As a long-only fund, this is not a merger arb (long/short) call.

Cigna's stock has declined from $194.25 pre-announcement to $167.74, or 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 favor 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 favor of the transaction.

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). 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 that of some analysts that view regulatory signoff as "highly probable." (1) Cigna management believes that the transaction will close by yearend. 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.

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 favorable 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 yearend (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.

For the full report, including the valuation model, go to SumZero.