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Pharmacy-benefits company has attractive price, growth

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Express Scripts works with clients to control their spending on prescription drugs. Express Scripts Canada pharmacy manager Cory Cowan looks for medication amongst the rows of the company's stores in Mississauga on May 18, 2012. (Deborah Baic/The Globe and Mail)DEBORAH BAIC/THE GLOBE AND MAIL

A Globe and Mail reporter recently pointed out that many Canadian portfolios suffer from "home bias," an overexposure to Canadian equities. We have a prescriptive solution.

Express Scripts Holding Co. is the largest pharmacy benefit management company in North America. It serves thousands of clients including managed-care organizations, insurance carriers, employers, third-party administrators, public sector and union-sponsored benefit plans.

The industry is an obscure one and one that most people are unfamiliar with. Pharmacy benefit management services include claims processing, home delivery services, and benefit-design consultation, among others. Health-care spending in North America continues to grow at rates well in excess of inflation and consumes an ever larger share of gross domestic product. Express Scripts works with clients to control their spending on prescription drugs.

Express Scripts processes 1.4 billion prescriptions a year. It uses its scale to negotiate favourable rates with pharmacies, pharmaceutical manufacturers, drug wholesalers and others in the drug supply chain. The company passes along most of the savings to its clients and keeps a sliver of profit from each prescription for itself. The size of that sliver keeps growing each year, since the cost of processing an additional prescription for an existing customer is very low.

The long-term fundamentals of the pharmacy benefit management industry are attractive. An aging demographic provides a tailwind, as drug usage will continue to climb, only increasing the need to find ways to reduce health-care costs. Annual drug price inflation also works in the sector's favour.

Given the scale needed to succeed, a few dominant firms have grown to control most of the market over time. High switching costs for customers and regulatory complexity also help these companies to continually widen their economic moats.

The biggest risk Express Script faces is losing clients at renewal to a competitor. It lost some market share last year as management was distracted by the $29.1-billion (U.S.) acquisition of rival Medco Health Solutions in 2012. Integration efforts have taken time and led to higher-than-normal customer turnover as client retention fell to 92 per cent.

Express Scripts does have competitors – CVS Caremark and TSX-listed Catamaran Corp. to name two – and contracts are typically put out to bid at renewal. However, we suspect that the request for proposal process is largely used as a means of keeping the incumbent's pricing in check. Client retention rates routinely exceed 95 per cent, and we expect Express Scripts to reach or exceed that historical rate again.

Management's long-term guidance to deliver 10-per-cent to 20-per-cent annual earnings per share growth over the long term appears reasonable to us, given their historical track record.

At our recent purchase price of $68.66, which is less than nine times adjusted pretax earnings, we viewed the stock as undervalued. Despite the stock's recent move higher, we still believe the stock is worth purchasing. Management seems to share our view – the company has repurchased over $6.7-billion worth of stock over the past year and a half and reduced the outstanding share count by 9 per cent, while maintaining its investment-grade rating.

Closer to home, we could have invested in Catamaran Corp. However, we prefer to invest based on the quality of the business and the attractiveness of the purchase price, not geography. When you can invest in the industry leader at a discount to both its competitors and the overall market, in our minds the preferred choice is clear: Buy quality when it is on sale.

The geography of the company involved does matter but for a different reason than you may think. Our investment approach is to invest in great companies domiciled and operating primarily in shareholder-friendly jurisdictions. Canada, the United States and Western Europe all meet this test. We believe that supremacy of the rule of law combined with their global operations provides a lower risk method of gaining exposure to faster growing developing economies.

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