

## Global Biotechnology

# Biopharma and managed care: UNH reaches out to pharma to manage rebate change, but change is hard and pain will spread

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*In conversation with industry contacts we learned about a letter sent by UNH to pharma companies, which made a few demands about drug price reduction. We have since confirmed the existence of the letter with two large drug companies. Here, we comment on the letter's contents, how it should be interpreted and its implications for the sector.*

**What happened?** The OptumRx unit of UNH appears to have sent a letter, (which appears uniform across all major biopharmas that received it) where they demand: (i) at least seven quarters notice ahead of any list-price reduction; (ii) equivalent rebates off lowered prices as compared with existing prices (although it's unclear if they expect rebates to remain constant in an absolute sense or as a percentage of price).

**Drug companies are not too happy about it** (and that's putting it mildly). *First*, many are considering list price reduction for high gross-to-net products. Lower list prices reduce patient copay burden and distribution costs since both of which are linked to sticker price rather than net-price. *Second*, they were displeased with the attitude UNH took "playing the heavy" trying to dictate terms and timing of large scale projects. While recognized as an opening stance in negotiations, the magnitude of the rebate demands by UNH were "ludicrous" and would force drug makers to rethink price reductions unless they were significantly moderated.

**What is UNH doing and why?** UNH (and likely other PBMs) are likely trying to ensure lead time to modify the structure of insurance products which benefit from rebates. The most basic change for Part D and commercial plans would be to lower out of pocket exposure for drugs and offset this with increased premiums.

We believe the lead time to enable this shift is two years, with Part D and MA plans shifting to higher premiums but lower out of pocket for drugs for 2020. Because changes to the employer segment would require legislation or more significant industry practice changes, we assume this would not occur before 2021. For the employer segment, employers would need to change their premiums and expected out of pocket expenses, which normally would be done at the beginning of the benefits year (usually Jan 1).

In addition, we believe PBMs are likely exploring how to recoup some of the lost gross margin they generate from retained rebates. We believe this will lead to margin compression for PBMs.



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Bernstein Events



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## TICKER TABLE

Ticker	Rating		7 Feb 2019 Closing Price	Target Price	TTM Rel. Perf.	EPS Adjusted			P/E Adjusted			
						2017A	2018E	2019E	2017A	2018E	2019E	
UNH	O	USD	269.00	306.00	18.2%	USD	12.87	14.80	17.01	20.90	18.18	15.82
AMGN	M	USD	184.23	200.00	2.9%	USD	12.60	14.40	14.68	14.63	12.79	12.55
AGN	O	USD	132.44	209.00	(23.2)%	USD	16.35	16.69	15.86	8.10	7.94	8.35
BIIB	M	USD	308.73	288.00	(6.5)%	USD	21.81	26.24	30.50	14.15	11.76	10.12
CELG	O	USD	87.47	106.00	(9.0)%	USD	7.44	8.89	10.63	11.75	9.84	8.23
JAZZ	M	USD	125.07	146.00	(13.5)%	USD	11.04	13.41	14.62	11.33	9.33	8.55
MYL	O	USD	30.35	39.00	(25.9)%	USD	4.56	4.60	5.41	6.66	6.60	5.61
REGN	M	USD	406.46	375.00	20.6%	USD	16.31	22.82	23.00	24.92	17.81	17.67
TEVA	M	USD	18.35	26.00	(12.9)%	USD	4.01	3.03	2.81	4.57	6.05	6.53
SPX			2,706.05				128.74	159.07	168.68	21.02	17.01	16.04

O - Outperform, M - Market-Perform, U - Underperform, N - Not Rated

UNH base year is 2018;

## INVESTMENT IMPLICATIONS

We rate UNH Outperform with a target price of \$306, AMGN Market-Perform with a target price of \$200, AGN Outperform with a target price of \$209, BIIB Market-Perform with a target price of \$288, CELG Outperform with a target price of \$106, JAZZ Market-Perform with a target price of \$146, MYL Outperform with a target price of \$39, REGN Market-Perform with a target price of \$375, and TEVA Market-Perform with a target price of \$26.

## DETAILS

**Bottom-line: change is hard.**

+ **The part D reform may not impact biopharma directly, but will do so indirectly.** Taking a step back, what drug cost reform will do is to take money out of the industry. Different actions will hit different layers of the value chain but the economics of the different layers are intertwined. UNH, the largest of the insurers/PBM complexes is basically telling biopharma is that to the extent reducing/eliminating rebates takes place, it will hurt their economics and they will seek to pass some of the financial losses to the drug manufacturers.

+ **Notice the shift in power dynamics.** The letter hasn't been made public by pharma companies. Instead, it's contents leaked to us indirectly through conversations with executives on deep background. Pharma's secrecy despite their anger testifies to the growing power of payers. Despite intense frustration over the demands in the letter, pharma execs are reluctant to go public with information that would cast UNH in a negative light (high list prices increase patients' copays to...UNH).

+ **Systemic change is likely but more gradual.** As the administration seeks to shift the entire drug market (beyond the part D business) away from the rebates and toward lower gross-to-net drug prices, the drug industry will be forced to reshuffle to accommodate the shift. However, the intertwined (and sometimes conflicting) economic interest of the industry's various layers will create friction and lead to more gradual, and perhaps incomplete, change.

+ **Where are the other payers/PBM** We believe all PBMs will similar interests in having adequate lead time, protecting their gross margins or finding the best structures to recoup some of this gross margin, and maintaining pressure on drug company net prices. We believe the lead time to enable this shift is two years. Importantly, we believe PBMs have contractual provisions which would enable them to renegotiate their client contracts so they are not obligated to pay rebate guarantees if rebates are no longer paid to the PBM.

## VALUATION METHODOLOGY

### Global Biotechnology

We value biotech companies based on DCF, PEG, and EV/NOPAT growth. We take into account consensus revisions by calculating how our estimates differ consensus.

## RISKS

### U.S. Healthcare Services

Price targets for all our covered companies are subject to full range of domestic U.S. macro-economic risks, such as GDP growth, unemployment rate, the pace of population aging, inflation and interest rate dynamics to fiscal spending, especially on healthcare, on both federal and state levels. As some of our covered companies continue to increase international presence outside of the U.S., currency fluctuations will become a more substantial risk. A number of industry specific factors will have significant impacts on the companies' future earnings, including medical cost trends, premium rate trends for government businesses and public exchange, industry-wide health insure tax, government spending on healthcare, and government regulations on healthcare costs, such as pharmaceuticals. That said, in most cases, the key drivers to outperformance against industry peers and attractive shareholder return is each company's ability to generate organic growth, achieve market share gains, execute on margin expansion plans (and integration initiatives post mergers for covered companies), and allocate capital efficiently and effectively. Finally, the valuation of the broader market has recovered but is subject to higher growth expectations and market volatilities. The valuation of the broader market might contract if we don't see quality growth meeting market expectations and this would also impact the valuation of our covered companies.

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### 12-Month Rating History as of 02/07/2019

#### Ticker Rating Changes

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AGN	O (DC)	06/15/15	
AMGN	M (IC)	06/28/16	
BIIB	M (RC)	10/19/18	O (IC) 06/28/16
CELG	O (RC)	05/23/18	M (RC) 12/27/17
JAZZ	M (IC)	11/25/15	
MYL	O (RC)	09/10/13	
REGN	M (RC)	06/26/17	
TEVA	M (RC)	08/04/17	
UNH	O (IC)	06/15/16	

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Rating Guide: O - Outperform, M - Market-Perform, U - Underperform, N - Not Rated

Rating Actions: IC - Initiated Coverage, DC - Dropped Coverage, RC - Rating Change

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