

Hidden Profits In the Prescription Drug Supply Chain

WSJ [wsj.com/articles/hidden-profits-in-the-prescription-drug-supply-chain-1519484401](https://www.wsj.com/articles/hidden-profits-in-the-prescription-drug-supply-chain-1519484401)

February 24, 2018



Pharmacy benefit managers are far more profitable than they seem, which makes them vulnerable to new competitors. Photo: bryan woolston/Reuters

By

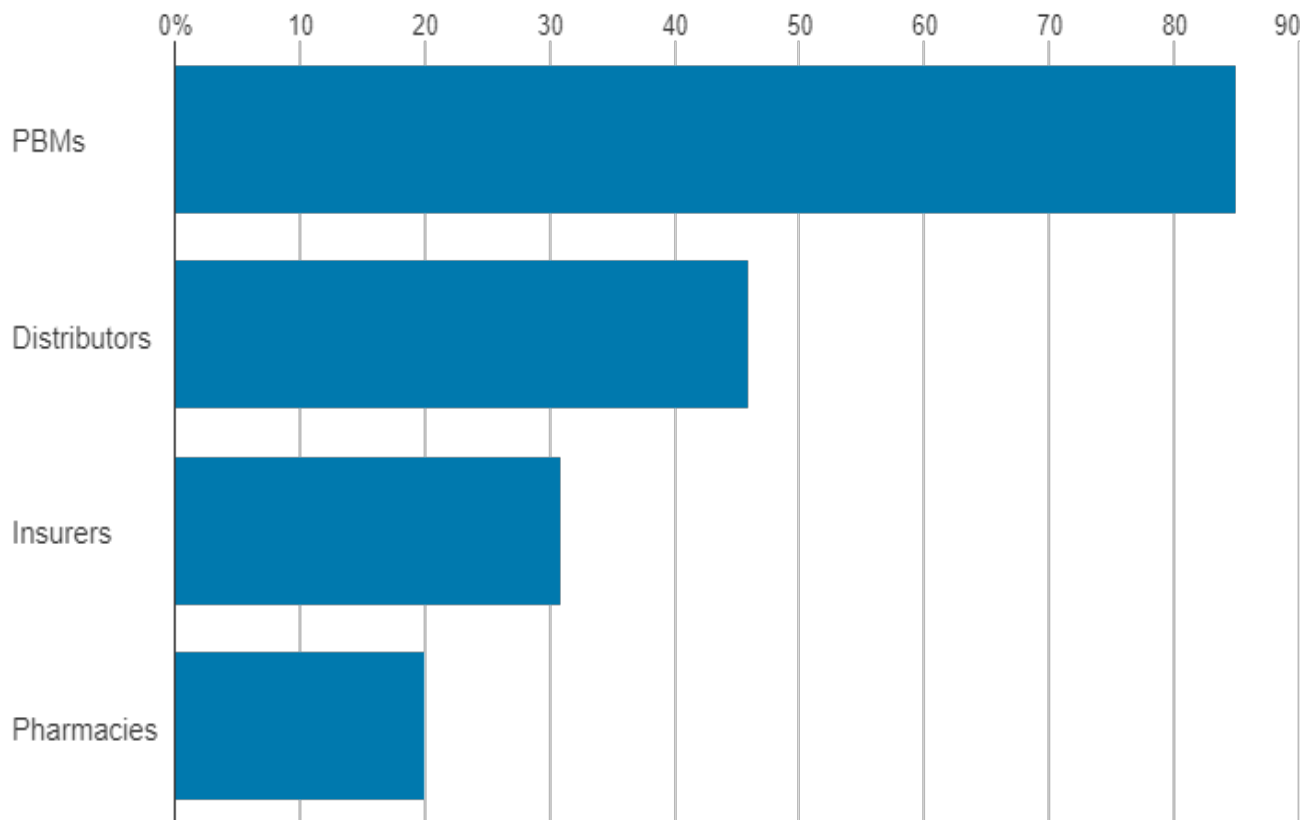
Feb. 24, 2018 10:00 a.m. ET

Depending on how you look at them, pharmacy-benefit managers are either low-margin middlemen that fight to reduce drug costs, or highly profitable intermediaries that take a cut of every prescription and earn more when drug prices rise.

Pharmacy-benefit managers are hired by businesses such as insurers that pay for drugs to negotiate lower prices with pharmaceutical companies. When the largest pharmacy-benefits manager, Express Scripts Holding, reports fourth quarter earnings on Tuesday, analysts expect a profit margin of just 4.7%, according to FactSet. Rival companies owned by CVS Health CVS -0.28% and UnitedHealth Group UNH +0.06% report similarly low margins.

But a closer look shows the business is far more attractive than those low margins would suggest. Included in Express Scripts' revenue is the cost of the underlying drugs they sell. Thus Express Scripts generated gross profit of just \$1.8 billion on total sales of \$24.7 billion in the third quarter. Gross profit is revenue minus the cost of goods sold, but nothing else.

In general, however, the pharmacy-benefits manager doesn't actually take delivery of the drug. That means these companies don't spend much on fixed assets, which keeps selling and administrative costs, as well as depreciation and amortization charges, very low.



Analysts at Bernstein tried to get a better picture of how profitable these companies are by excluding the cost of the drugs that are included in their revenue. The analysts compared the rate at which gross profit converts into earnings before interest, taxes, depreciation and amortization for pharmacy-benefits managers and other pieces of the drug supply chain, including drug distributors, insurers and pharmacies.

By this analysis, pharmacy-benefit managers are exceptionally profitable; 85% of their gross profit converted into Ebitda over the past two years. Drug distributors converted 46% of their gross profit, while health insurers and pharmacies achieved about 30%.

The analysts say these companies benefit from “lack of transparency and misaligned incentives,” the latter because they benefit from higher drug prices. Historically those dynamics have been great news for shareholders.

But now those dynamics have attracted new competition. One insurance giant, Anthem, is starting their own pharmacy-benefits manager. Potential competition could come from other sources, like the announced nonprofit joint health-care venture between Amazon, Berkshire Hathaway and JPMorgan Chase . A White House report issued earlier this month suggested excessive PBM market concentration might actually drive drug costs higher.

Pharmacy-benefit managers would only get this attention if their business was attractive. It

may not be for much longer.

Write to Charley Grant at charles.grant@wsj.com