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Healthcare Mergers (CVS/Aetna and Cigna/ESRX): Puts & Takes

Summary: The purpose of this report is to review the various puts and takes of stakeholders along the drug supply chain as the merger transactions of both CVS-Aetna and Cigna-Express Scripts undergo regulatory review by the Department of Justice (DOJ) Antitrust Division. We review the current market structure of the pharmacy benefit managers (PBMs), the health insurers and the Government payer (Medicare Part D) as well as three possible criteria by which the transactions could be judged by the DOJ. Finally, we state our preliminary conclusion at the end of the report as to the likelihood of the mergers being challenged by the DOJ and the reasons for doing so.

I. Market Event

Cigna (CI) announced on March 8 its intent to buy Express Scripts (ESRX) for $54B. The proposed merger comes in the wake of a similar pending buyout of Aetna (AET) by CVS Health (CVS) for $69B, leading to tighter vertical integration in the healthcare sphere between pharmacy benefit managers (PBM) and health insurance providers.

Both deals come as the healthcare industry is working to find value-focused solutions to rising healthcare costs. In 2016, the $3.3 trillion dollars in healthcare spending made up 17.9% of the U.S. gross domestic product. Both Cigna-Express Scripts and CVS-Aetna mergers appear focused on personalized care through the use of analytics. The CVS-Aetna merger is aimed at turning CVS Pharmacy into the "front door of healthcare," while Cigna's goal is to streamline the way healthcare is delivered by physicians while making medical, behavioral, specialty pharmacy and other services accessible through more channels.

II. Federal Antitrust Jurisdiction

According to lawyers, the Express Scripts deal will probably be reviewed by the Department of Justice Antitrust Division rather than the Federal Trade Commission (FTC). The division handles health insurance mergers and successfully blocked Cigna's sale to Anthem Inc. last year. While the FTC investigates mergers involving PBMs, the Justice Department is investigating the CVS-Aetna deal, which combines an insurer and a PBM.

The Justice Department is rethinking how to approach transactions that combine firms operating at different points in an industry supply chain. These vertical integration mergers do not raise the same kind of competitive harms that come when direct competitors combine (i.e., horizontal integration mergers).

Yet there are risks that these vertical tie-ups could enable Cigna and CVS to disadvantage their rivals as well as limit the ability of large employers to choose who manages both prescription drug benefits and medical coverage for their employees. Most national companies with more than 20,000 employees use different companies to provide prescription drug benefits and medical coverage, according to Express Scripts CEO Tim Wentworth.

In addition, antitrust experts say that the Trump administration would need to review how both deals would affect the U.S. market, already the world's most expensive healthcare system.

- *David Balto, antitrust lawyer with expertise in the health industry:* Having two simultaneous deals significantly raises the risk. There's a significant risk that both deals get challenged.

- *Tim Greaney, professor at University of California Hastings College of the Law:* From an antitrust perspective, Cigna and Express Scripts may get a particularly close look because their deal comes on the heels of the CVS announcement, ensuring that the two will likely be reviewed in tandem. Judges blocked two previous giant managed care mergers that were also reviewed in lockstep, between Anthem and Cigna and between Aetna and Humana. The new deals, which bring together companies with limited direct overlap, are expected to face fewer barriers.

  For years, competitive harm from vertical deals has been resolved by putting conditions on how companies operate. But the Justice Department antitrust division under Trump has thrown out that playbook, arguing that behavioral remedies force antitrust enforcers to become regulators who monitor whether companies comply with the conditions. That view prompted the government's lawsuit against AT&T Inc.'s proposed takeover of Time Warner Inc.

- *Hunton & Williams, antitrust law firm in Washington, D.C.:* The Justice Department has made clear its opposition to behavioral remedies, so that fix is unlikely to win the day for Cigna.

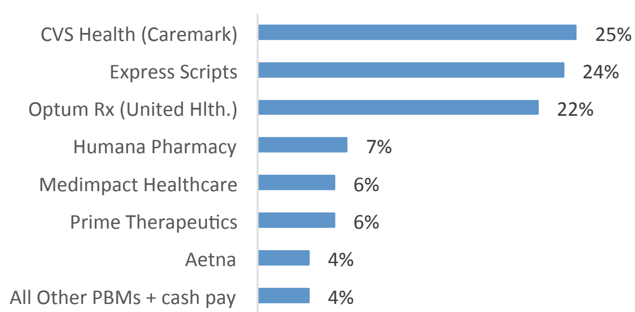
- *Jennifer Rie, Bloomberg Intelligence analyst:* Cigna will probably win approval for the takeover from enforcers. Cigna would need market power to effectively discriminate against rivals, but with other large insurers in the market, that risk is less likely.

III. Market Structure

A. Pharmacy Benefit Managers (PBMs)

Express Scripts is the second-biggest pharmacy benefit manager in the U.S. behind CVS's Caremark business. Along with OptumRx, a unit of UnitedHealth Group Inc., the three PBMs have a combined market share of 70% according to estimates by *Drug Channels Institute* (see Figure 1).

FIGURE 1: Top U.S. PBMs by Prescription Claims Market Share, 2017 (%)



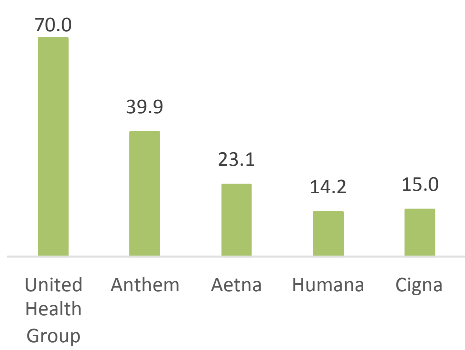
Source: Drug Channels Institute, 2018

The PBMs handle drug benefits for insurers and employers, negotiating prices with drug makers. They have come under particular pressure in recent weeks, with President Trump's *Council of Economic Advisers* criticizing the companies' market power and the opacity of their drug price contracts.

B. Health Insurance Payers

Based on a report by the *American Medical Association (AMA)*, health insurance markets across the U.S. are becoming increasingly concentrated, making them ripe for payers to exercise market power that can negatively impact patients and healthcare providers. The report found that in 43% of metropolitan areas in 2016, a single health insurer had at least a 50% share of the market. Whereas in 2014, the market share was 40% of metropolitan areas. In other words, the commercial health insurance market became more concentrated from 2014 to 2016 in 27 states. Overall, 69% of metropolitan areas had a significant absence of health insurer competition in 2016 – earning them a “highly concentrated” rating based on federal guidelines used to assess market competition. Figure 2 shows the top 5 health insurance payers by the number of subscribers.

FIGURE 2: Top 5 U.S. Health Insurance Payers, by No. of Subscribers (in Million)



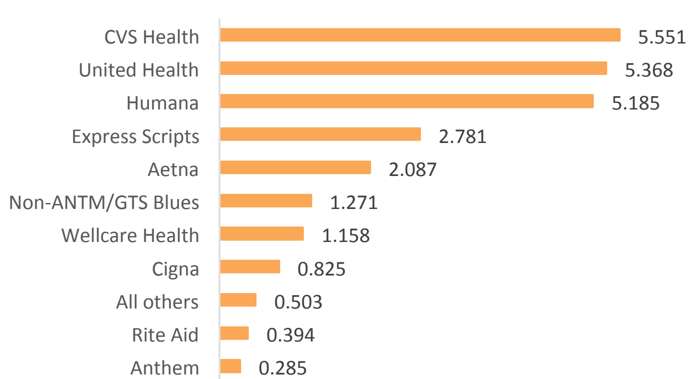
Anthem, the *AMA* noted, dominated the rest of the pack by being largest health insurer by market share in 82 out of 389 metropolitan areas that the trade group examined. Health Care Service Corp. had a market share lead in 42 out of 389 metropolitan areas, while UnitedHealth led in 26 areas. Two separate federal judges have prevented further insurer consolidation by blocking the Aetna-Humana and Anthem-Cigna mergers, decisions that the *AMA* cheered. Both Aetna and Anthem ultimately decided to abandon the deals.

Source: HealthPayer Intelligence, April 2017

<u>Note #1:</u> The announcement of Cigna’s intent to buy Express Scripts on March 8, marks nearly one year since a federal judge blocked a $54B Cigna-Anthem merger, saying that the combination of the two providers would raise prices and reduce competition. Cigna subsequently sued Anthem in February 2017 for a $1.85B breakup fee plus $13B in damages resulting from the failed merger attempt, and Anthem countersued. The companies are slated to go to trial in 2019.

C. Medicare Part D Prescription Benefits Program

FIGURE 3: Total Medicare Part D Enrollment, by Company (in Million)



Both the Cigna-Express Scripts and the CVS-Aetna deals will lead to greater consolidation in the Medicare Part D prescription space. An analysis from the *Kaiser Family Foundation* found that a Cigna and Express Scripts merger would further compress the number of Medicare prescription drug benefit providers, otherwise known as Medicare Part D. Figure 3 ranks the top Medicare Part D plan sponsors by their total membership.

Source: Wells Fargo, The Wall Street Journal, 10/6/17

If Cigna buys Express Scripts and CVS merges with Aetna, it would give these firms an outsize role in formulary coverage decisions in Part D, since there would be four firms in control of 86% of the stand-alone drug plan. More than 70% of the nearly 59M Americans enrolled in Medicare are enrolled in Part D's prescription benefits, roughly 42M people, according to a 2017 analysis from the *Kaiser Family Foundation.*

IV. Evaluation Criteria

Criterion #1: Will the mergers create less access and choice to prescription drugs and medical services (i.e., as a result of lesser competition in the healthcare space)?

- *Kaiser Family Foundation's program on Medicare policy:* Through negotiations with pharmaceuticals, PBMs can place drugs on non-preferred tiers or deny coverage of specific medications. If plan consolidation means fewer formularies, that could leave patients with fewer options for finding coverage of the drugs they take. In other words, these moves toward further consolidation could effectively decrease Part D enrollees' options in terms of coverage and finding drugs they need on plan formularies.

- *Families USA, a Washington, D.C. nonprofit focused on achieving affordable healthcare:* Express Scripts serves a handful of other large health insurance companies, such as Blue Cross Blue Shield and Molina Healthcare. With the proposed Cigna-Express Scripts merger, there are many questions as to how Express Scripts' relationships with other companies will play out. A Cigna-Express Scripts deal could create a scenario where the two companies establish preferential treatment toward one another that could in turn drive up costs or restrict access for those served by other companies. These questions and concerns will be raised throughout the regulatory process and as they are answered, it is important that there are clear consumer benefits emerging from this deal and not just proposed gains for the companies. If two companies are going to merge, they should actually provide better results for consumers as they become a new entity.

- *National Community Pharmacists Association:* One thing is clear, consolidation among healthcare giants leads to fewer choices for patients and plan sponsors. A narrowing field of industry players could have big consequences on patients. We're seeing the growing balkanization of the healthcare industry – a world in which patients may be forced into a healthcare kingdom – the CVS-Aetna kingdom, the Cigna-Express Scripts kingdom, the UnitedHealth-OptumRx kingdom, etc. – where the borders are not porous, and patients are stuck with what they get. Depending on where you live, that lack of choice could disadvantage patients who are trapped in inflexible pharmacy and healthcare networks that dictate the decision-making process for the delivery of care.

Criterion #2: Will both mergers result in Lower Drug Prices?

- *Kaiser Family Foundation's program on Medicare policy:* A Cigna-Express Scripts merger would give the combined company greater market share power which in turn strengthens its ability to leverage better drug costs with drug providers. Moreover, pharmaceutical companies negotiate with PBMs for greater market share exposure of their products by offering steeper rebates in exchange for favorable formulary placement.

- *National Community Pharmacists Association:* While in theory, consolidation should lead to greater prescription price leverage, in practice, lower drug costs have not been the case after PBMs and health insurers merge. Companies make claims of cost savings that will benefit patients and health plan sponsors, but the available evidence from previous consolidations suggests otherwise. For example, the merger of UnitedHealth (UNH) and Catamaran (a mid-market PBM) did not change the upward trajectory in healthcare spending. The UNH merger with Catamaran closed in 2015 for $12.8B. In March, UNH announced the rollout of pharmacy discounts for which 7M of the nearly 65M customers (~11%) would be eligible. Discounts are not set to take hold until January 1, 2019.

- *Jason McGorman, Sr. Equity Healthcare Analyst, Bloomberg Intelligence:* Cigna's pledge to drive down costs could be realized because the provider already has a well-established model of cost cutting. In addition, Cigna's close ties to physicians and focus on local expertise will likely be a great match for Express Scripts' expertise in formularies and specialty drugs. Cigna will try to leverage technology to identify gaps where savings can be made in drug spending among Express Scripts members.

- *Families USA, a Washington, D.C. nonprofit focused on achieving affordable healthcare:* A cost reduction forecast from the merger is really just a wait and see. The key question is – will consumers see benefits from the mergers or will only shareholders see benefits from the mergers.

- *Tom Borzilleri, CEO of InteliSys Health, former CEO & Founder of PBM Valore' Rx:* The merger is not going to drive savings for Cigna and Express Scripts' customers, including other health plans, employers and patients. It's just not going to happen. This is more a move to drive further profitability, but there isn't any anticipated trickle-down effect for customers. This story has played out before when UnitedHealth's OptumRx unit bought PBM Catamaran, promising efficiencies and savings for the customers, but those benefits never materialized. Copays and deductibles have continued to climb.

- *Pramod John, CEO & Founder of Vivio Health, a specialty pharmacy management firm:* The notoriously secretive PBM industry is also unlikely to become more transparent. PBMs are the middlemen that build formularies and negotiate drug rebates from pharmaceutical manufacturers. While they pass some of that rebate on to health plans and contracted employers, they also pocket a portion (i.e., "spread pricing"). Confidential contracts make it difficult to know just how much they keep. With all these insurer-PBM mergers, none of them have shown to benefit the consumer. OptumRx has some of the highest pricing and is resistant to sharing data. Now there is less transparency because the lines between payer and provider are being blurred.

Note #2: Express Scripts is dealing with a lawsuit brought by its biggest client Anthem in early 2016, alleging the pharmacy benefit manager did not pass along billions in savings from negotiated drug prices. Anthem since then said it would not renew its PBM contract with Express Scripts. The loss of Anthem threatened Express Scripts' ability to continue as one of the last stand-alone PBMs.

- *Gurpreet Singh, health services sector leader at consultancy PricewaterhouseCoopers:* In addition to using its scale to negotiate better deals with specialty drug manufacturers, the combined Cigna-Express Scripts could use medical and pharmacy data to improve medication adherence. This removes some of the inefficiency between drug pricing and those negotiated deals. It could illuminate the black box of PBMs and allow for better transparency and better cost efficiency.

Criterion #3: Will both mergers produce higher quality of care for patients?

- *Anders Gilberg, Sr. VP of Government Affairs of Medical Group Management Association in Washington, D.C.:* A stronghold in formulary coverage decisions could lead to lower prices, as Cigna contends, but conversely may result in significant cutbacks in the medications available to the insured. While formulary consolidation may be administratively efficient, this may not outweigh potential limitations on physician and patient choice of treatment.

V. ***Preliminary Conclusion***

Predicting the outcome of a Justice Department antitrust review is always tricky, especially when there are not one but two mergers up for consideration. Furthermore, these companies Cigna-Express Scripts and CVS-Aetna are vertically integrated along the drug supply chain with no large overlaps among their business units. However, both PBMs (ESRX and CVS Caremark) and health insurers (Aetna and Cigna) are dominant players in their own respective spaces that are already known to be highly concentrated pre-merger. We believe the issue of high concentration will play a substantial role in the antitrust review process, especially if both mergers are reviewed in tandem.

As our preliminary conclusion, we believe the mergers of both CVS-Aetna and Cigna-Express Scripts will be challenged by the DOJ Antitrust Division as it finds the transactions to be harmful to the interests of all the players in the healthcare space: the consumer, the providers, the payers, and the retail/specialty pharmacies. We believe the DOJ will challenge both mergers on grounds that post-merger, drug prices will likely continue to rise as fewer formularies and no independent PBMs mean less aggressive negotiations with drug manufacturers for drug rebates and discounts. Furthermore, there will be fewer choices of pharmacy and healthcare networks for consumers and Government programs (Medicare and Medicaid) to choose from after the mergers, as less competition leads to decreased access to prescription drugs and medical services.

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