Global Biotechnology

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

Aaron (Ronny) Gal, Ph.D.
+1-212-756-4208
ronny.gal@bernstein.com

Lance Wilkes
+1-212-407-5826
lance.wilkes@bernstein.com

Andy Chen, Ph.D., CFA
+1-212-823-2732
andy.chen@bernstein.com

Betty Huang
+1-212-756-4602
betty.huang@bernstein.com

Robin Qiu
+1-212-407-5834
robin.qiu@bernstein.com

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.

Analyst Page Bernstein Events Industry Page

TICKER TABLE

Ticker	Rating		7 Feb 2019 Closing Price	Target Price	TTM Rel. Perf.		EPS Adjusted 2017A	EPS Adjusted 2018E	EPS Adjusted 2019E	P/E Adjusted 2017A	P/E Adjusted 2018E	P/E Adjusted 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.

SRO REQUIRED DISCLOSURES

- References to "Bernstein" relate to Sanford C. Bernstein & Co., LLC, Sanford C. Bernstein Limited, Sanford C. Bernstein (Hong Kong) Limited 盛博香港有限公司, Sanford C. Bernstein (Canada) Limited, Sanford C. Bernstein (India) Private Limited (SEBI registration no. INH000006378) and Sanford C. Bernstein (business registration number 53193989L), a unit of AllianceBernstein (Singapore) Ltd. which is a licensed entity under the Securities and Futures Act and registered with Company Registration No. 199703364C, collectively.
- Bernstein analysts are compensated based on aggregate contributions to the research franchise as measured by account penetration, productivity and proactivity of investment ideas. No analysts are compensated based on performance in, or contributions to, generating investment banking revenues.
- Bernstein rates stocks based on forecasts of relative performance for the next 6-12 months versus the S&P 500 for stocks listed on the U.S. and Canadian exchanges, versus the MSCI Pan Europe Index for stocks listed on the European exchanges (except for Russian companies), versus the MSCI Emerging Markets Index for Russian companies and stocks listed on emerging markets exchanges outside of the Asia Pacific region, and versus the MSCI Asia Pacific ex-Japan Index for stocks listed on the Asian (ex-Japan) exchanges - unless otherwise specified. We have three categories of ratings:

  Outperform: Stock will outpace the market index by more than 15 pp in the year ahead.

  Market-Perform: Stock will perform in line with the market index to within +/-15 pp in the year ahead.

  Underperform: Stock will trail the performance of the market index by more than 15 pp in the year ahead.

  Not Rated: The stock Rating, Target Price and/or estimates (if any) have been suspended temporarily.
- As of 02/07/2019, Bernstein's ratings were distributed as follows: Outperform - 51.3% (0.0% banking clients) ; Market-Perform - 38.7% (0.0% banking clients); Underperform - 9.9% (0.0% banking clients); Not Rated - 0.0% (0.0% banking clients). The numbers in parentheses represent the percentage of companies in each category to whom Bernstein provided investment banking services within the last twelve (12) months.
- A member of the research staff had been employed by and received compensation from Amgen Inc. ("AMGN") within the past 12 months.
- Accounts over which Bernstein and/or their affiliates exercise investment discretion own more than 1% of the outstanding common stock of the following companies BIIB / Biogen Inc, REGN / Regeneron Pharmaceuticals Inc.
- This research publication covers six or more companies. For price chart disclosures, please visit www.bernsteinresearch.com/go/disclosures, you can also write to either: Sanford C. Bernstein & Co. LLC, Director of Compliance, 1345 Avenue of the Americas, New York, N.Y. 10105 or Sanford C. Bernstein Limited, Director of Compliance, 50 Berkeley Street, London W1J 8SB, United Kingdom; or Sanford C. Bernstein (Hong Kong) Limited 盛博香港有限公司, Director of Compliance, 39th Floor, One Island East, Taikoo Place, 18 Westlands Road, Quarry Bay, Hong Kong, or Sanford C. Bernstein (business registration number 53193989L) , a unit of AllianceBernstein (Singapore) Ltd. which is a licensed entity under the Securities and Futures Act and registered with Company Registration No. 199703364C, Director of Compliance, One Raffles Quay, #27-11 South Tower, Singapore 048583.

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

Ticker	Rating Changes	
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	

Rating Guide: O - Outperform, M - Market-Perform, U - Underperform, N - Not Rated
Rating Actions: IC - Initiated Coverage, DC - Dropped Coverage, RC - Rating Change

OTHER DISCLOSURES

A price movement of a security which may be temporary will not necessarily trigger a recommendation change. Bernstein will advise as and when coverage of securities commences and ceases. Bernstein has no policy or standard as to the frequency of any updates or changes to its coverage policies.

Although the definition and application of these methods are based on generally accepted industry practices and models, please note that there is a range of reasonable variations within these models. The application of models typically depends on forecasts of a range of economic variables, which may include, but are not limited to, interest rates, exchange rates, earnings, cash flows and risk factors that are subject to uncertainty and also may change over time. Any valuation is dependent upon the subjective opinion of the analysts carrying out this valuation.

Bernstein produces a number of different types of research product including, among others, fundamental analysis and quantitative analysis. Recommendations contained within one type of research product may differ from recommendations contained within other types of research product, whether as a result of differing time horizons, methodologies or otherwise.

This document may not be passed on to any person in the United Kingdom (i) who is a retail client (ii) unless that person or entity qualifies as an authorised person or exempt person within the meaning of section 19 of the UK Financial Services and Markets Act 2000 (the "Act"), or qualifies as a person to whom the financial promotion restriction imposed by the Act does not apply by virtue of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005, or is a person classified as an "professional client" for the purposes of the Conduct of Business Rules of the Financial Conduct Authority.

This document may not be passed onto any person in Canada unless that person qualifies as "permitted client" as defined in Section 1.1 of NI 31-103.

To our readers in the United States: Sanford C. Bernstein & Co., LLC is distributing this publication in the United States and accepts responsibility for its contents. Any U.S. person receiving this publication and wishing to effect securities transactions in any security discussed herein should do so only through Sanford C. Bernstein & Co., LLC.

To our readers in the United Kingdom: This publication has been issued or approved for issue in the United Kingdom by Sanford C. Bernstein Limited, authorised and regulated by the Financial Conduct Authority and located at 50 Berkeley Street, London W1J 8SB, +44 (0)20-7170-5000.

To our readers in member states of the EEA: This publication is being distributed in the EEA by Sanford C. Bernstein Limited, which is authorised and regulated in the United Kingdom by the Financial Conduct Authority and holds a passport under the Markets in Financial Instruments Directive.

To our readers in Hong Kong: This publication is being distributed in Hong Kong by Sanford C. Bernstein (Hong Kong) Limited 盛博香港有限公司, which is licensed and regulated by the Hong Kong Securities and Futures Commission (Central Entity No. AXC846). This publication is solely for professional investors only, as defined in the Securities and Futures Ordinance (Cap. 571).

To our readers in Singapore: This publication is being distributed in Singapore by Sanford C. Bernstein, a unit of AllianceBernstein (Singapore) Ltd., only to accredited investors or institutional investors, as defined in the Securities and Futures Act (Chapter 289). Recipients in Singapore should contact AllianceBernstein (Singapore) Ltd. in respect of matters arising from, or in connection with, this publication. AllianceBernstein (Singapore) Ltd. is a licensed entity under the Securities and Futures Act and registered with Company Registration No. 199703364C. It is regulated by the Monetary Authority of Singapore and located at One Raffles Quay, #27-11 South Tower, Singapore 048583, +65-62304600. The business name "Bernstein" is registered under business registration number 53193989L.

To our readers in the People's Republic of China: The securities referred to in this document are not being offered or sold and may not be offered or sold, directly or indirectly, in the People's Republic of China (for such purposes, not including the Hong Kong and Macau Special Administrative Regions or Taiwan), except as permitted by the securities laws of the People's Republic of China.

To our readers in Japan: This document is not delivered to you for marketing purposes, and any information provided herein should not be construed as a recommendation, solicitation or offer to buy or sell any securities or related financial products.

For the institutional client readers in Japan who have been granted access to the Bernstein website by Daiwa Securities Group Inc. ("Daiwa"), your access to this document should not be construed as meaning that Sanford C. Bernstein is providing you with investment advice for any purposes. Whilst Sanford C. Bernstein has prepared this document, your relationship is, and will remain with, Daiwa, and Sanford C. Bernstein has neither any contractual relationship with you nor any obligations towards you.

To our readers in Australia: Sanford C. Bernstein & Co., LLC, Sanford C. Bernstein Limited and Sanford C. Bernstein (Hong Kong) Limited 盛博香港有限公司 are exempt from the requirement to hold an Australian financial services licence under the Corporations Act 2001 in respect of the provision of the following financial services to wholesale clients:

- providing financial product advice;
- dealing in a financial product;
- making a market for a financial product; and
- providing a custodial or depository service.

To our readers in Canada: If this publication is pertaining to a Canadian domiciled company, it is being distributed in Canada by Sanford C. Bernstein (Canada) Limited, which is licensed and regulated by the Investment Industry Regulatory Organization of Canada ("IIROC"). If the publication is pertaining to a non-Canadian domiciled company, it is being distributed by Sanford C. Bernstein & Co., LLC, which is licensed and regulated by both the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority ("FINRA") into Canada under the International Dealers Exemption. This publication may not be passed onto any person in Canada unless that person qualifies as a "Permitted Client" as defined in Section 1.1 of NI 31-103.

CERTIFICATIONS

- I/(we), Aaron (Ronny) Gal, Ph.D., Lance Wilkes, Senior Analyst(s)/Analyst(s), certify that all of the views expressed in this publication accurately reflect my/(our) personal views about any and all of the subject securities or issuers and that no part of my/(our) compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views in this publication.

Approved By: SU

[AHEAD OF TOMORROW]