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Understanding and evaluating deal considerations in the pharmaceutical distribution sector

An update for private equity investors

This issue explores certain operational, financial, and tax issues that private equity investors should consider when making investments in entities in the pharmaceutical distribution sector, including wholesalers, retail pharmacy outlets and institutional settings like hospitals and clinics.

Operational considerations

Regulatory landscape and the Patient Protection and Affordable Care Act ("PPACA")—The Congressional Budget Office ("CBO") released a study in April 2014 that estimates that 19 million additional people will have health insurance coverage in 2015 than would have been covered in the absence of PPACA. This is due to insurance exchanges, Medicaid expansion, and the narrowing of the Medicare coverage gap (the "donut hole"). The CBO expects this trend to continue as approximately 25 to 26 million more people will be insured each year from 2016 to 2024 under the provisions of the PPACA. Sales growth will likely be driven by increased prescriptions from an aging population, PPACA lives, and drug inflation. These on-going changes to patient mix and drug reimbursement levels should be considered when assessing a target.

Narrowing networks—Many healthcare organizations, including pharmacy benefit managers ("PBMs"), have consolidated to create larger healthcare enterprises with greater market power, resulting in increased pricing pressures. Many insurers and PBMs are seeking to narrow their networks in an effort to control costs by limiting plan subscriber choices to a smaller group of medical care providers. In addition, by limiting choices, insurers may be able to better focus on the quality

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Specialty pharma growth—High-growth specialty drug markets, such as Oncology and Immunology, are driving double-digit growth in the specialty pharmacy industry where drug spend under pharmacy benefit is expected to more than double through 2018. By 2020, it is estimated that 9 out of the top 10 of the best-selling drugs by revenue in the United States will be specialty drugs according to EvaluatePharma's report entitled June 2014 World Preview 2014, Outlook to 2020. Due to the profitable nature of these drugs, many market participants are expanding both horizontally (e.g., wholesalers and retailers) and vertically (e.g., health systems) into the specialty pharmaceutical distribution space, which has led to increased competition for buyers to acquire targets in the sector.

Information technology commitments—Pharmacies and pharmaceutical distribution companies rely extensively on computer systems to manage ordering, pricing, point-of-sale, and inventory replenishment. As new regulations and technologies emerge, companies are often required to maintain and upgrade IT systems for operations and financial reporting. This technology is often used to combat increasing costs, including, but not limited to, cloud computing, electronic health record systems, and project management software. These internal projects result in cash and capital commitments, which should be considered in valuation models.

Information system disruptions—Systems utilized by pharmacies may be subject to interruption from power outages, viruses, and cyber security breaches. There is often a lack of communication between the pharmacy and financial operating systems, which causes reconciliation issues related to patient order and/or account data. These reconciliation issues may require shut-downs of systems, resulting in lost revenue that should be assessed during a quality of earnings analysis, and corrective actions, resulting in cash outlays that should be considered in valuation models.

Financial considerations

Branded to generic conversion—Increasing demand for effective and affordable medicines has caused a shift in the focus of many industry participants, led by payors, to enhanced value and affordability to offset rising healthcare costs. This shift in focus has resulted in a change from branded to generic drugs, as patients seek lower cost options for their medication. As patents expire for brand name drugs, additional markets open up for generic competition. Upon patent expiry, retailers and distributors often experience a temporary gross margin uplift during a brief period after converting to generic. During the conversion period, reimbursement may remain at elevated levels, while generic manufactures compete for market share. Further, to the extent not captured in existing inventory reserves, additional reserves may need to be established for the branded drugs as the conversion to generic occurs. While conversions are not atypical to the industry, the impact of significant branded to generic conversions should be considered when assessing historical quality of earnings.

Rebate estimates—Pharmacies and pharmaceutical distributors typically estimate rebate receivables based on purchasing volumes applied to agreed-upon rebate percentages. The estimates are adjusted as the rebates are deemed to be due, or as actual collections are received. Adjustments to normalize historical earnings typically result from a retrospective analysis of rebate estimates utilizing subsequent rebate collections. For smaller scale companies that report on a cash basis, there is potential exposure for uncaptured (i.e., unaccrued) rebates. Further, accruals that are based on estimates are not currently deductible for tax purposes. The methodology by which a target records rebates should be considered when assessing historical quality of earnings and evaluating historical tax exposures. In addition, rebate receivables should also be a focus area when analyzing the target level of working capital included in the purchase agreement as it is a significant management estimate.

Pricing pressures—The changing regulatory landscape due to the PPACA and narrowing networks has caused pricing pressures on pharmaceutical manufacturers, distributors, and pharmacies, which may negatively impact future earnings.

- **Maximum Allowable Cost Programs ("MAC")**—State Medicaid MAC programs establish an upper limit or maximum reimbursement amount for generic drugs and brand name drugs that have generic substitutes (multiple-source drugs), which serve as a vehicle to contain costs. The PPACA has provided additional funding for such programs, which drives the continued growth of generic usage and increases the potential that revenues and margins will be impacted due to the

narrowing of the gap between generic reimbursements and their cost.

- **Monitoring of specialty spend by states**—State Medicaid programs have begun to actively monitor the usage and coverage of high cost specialty products. To combat these increasing costs, states may impose usage restrictions and mandate lower reimbursement rates for certain products, which may create inconsistent earning patterns.
- **Out-of-network contracts with payors**—Out-of-network payments are often higher than in-network. However, this type of revenue carries the inherent risk of being more susceptible to changes in healthcare legislation, patient sentiment, and payor policy. Consideration should be given by a buyer to potential synergies and/or negative EBITDA impacts from obtaining in-network contracts with certain payors.

Wholesaler bulk purchasing—Drug wholesalers occasionally purchase extra inventory from pharmaceutical manufacturers in advance of a price increase. These companies receive a temporary benefit to their gross margin as purchases were made on old prices while sales are charged to end customers based on new pricing. This benefit should be considered in an analysis of historical quality of earnings.

Additional modeling and forecasting considerations—While some retailers and distributors have a mature history and understanding of their pharmacies' growth cycle from incurring start-up losses to reaching terminal profit level, other potential targets may not have the expertise and/or available data to properly forecast growth. Valuation models should consider the variability in historical growth rates driven by regional, demographic, and product differences. In addition, smaller operators may take salary through distributions and/or burden the income statement with personal expenses. Also, delivery systems, such as infusion pumps, are often used well past their useful life. Replacement of such equipment typically requires a significant capital outflow from a buyer that should be included in valuation models.

Tax considerations

Operating taxes—Various operating taxes apply to pharmaceutical distribution businesses. To the extent a company is not accounting for these taxes correctly, a buyer could become liable for an underpayment of historical operating taxes. Further, underreporting operating tax liabilities could also have a negative impact on reported EBITDA.

- **Sales and use taxes**—While most jurisdictions do not impose a sales tax on the sale of prescription pharmaceuticals, a limited number of jurisdictions (e.g., Illinois and local parishes in Louisiana) do impose such a tax. Further, certain jurisdictions may impose sales tax on the sale of ancillary products often sold with prescription pharmaceuticals (e.g., needles and epi pens), as well as non-prescription pharmaceuticals. Finally, certain jurisdictions impose a use tax to the extent sample prescription pharmaceuticals are provided to customers at no cost. A buyer should assess whether a target is properly remitting applicable sales and use taxes.
- **Gross receipts taxes**—A limited number of states (e.g., Ohio and Washington) impose a gross receipts tax on gross revenues in lieu of a business income tax. To the extent a pharmacy is acting in more than an agency capacity (e.g., taking title to pharmaceuticals or accepting risk with respect to reimbursement), as is generally the case, a buyer should assess whether a target is appropriately reporting and remitting applicable gross receipts taxes based on its gross revenues rather than its gross revenues less the cost of pharmaceuticals.

Traveling employees—Many specialty pharmacies employ individuals (e.g., salespersons) who travel to a number of jurisdictions on a regular basis. Depending on the activities performed and the amount of time spent in any particular jurisdiction, a target may have additional state and local tax filing and payment requirements in jurisdictions outside of its retail or office locations. A buyer should assess whether a target is properly remitting applicable taxes in jurisdictions where the activities of its employees create a filing obligation as a buyer could be liable for an underpayment of historical taxes in jurisdictions where it has not historically filed tax returns. Further, underreporting operating tax liabilities could also have a negative impact on reported EBITDA.

Cash basis—Retail pharmacies may be filing income tax returns on a cash basis. Depending on the tax structure that financial investors pursue, retail pharmacies may be required to report taxable income using the accrual-basis of accounting during post-closing tax periods. The conversion from the cash-basis of accounting to the accrual-basis of accounting may trigger taxable income, creating adverse tax implications for buyers and/or sellers. Accordingly, these tax implications should be addressed in the letter of intent so that the parties clearly understand who is responsible for the taxable income that may have been deferred as a result of cash-basis accounting.

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