Seeking Alpha α

Walgreen vs. Express Scripts: Animosity

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earnings impact of losing Express Scripts would likely be greater for two reasons. First, these patients may also be making purchases in the front of Walgreen's stores. Second, pharmacies have relatively fixed expense structures--costs such as rent and pharmacist salaries. This level of sales decline would likely result in some major negative operating leverage. Additionally, if an agreement is not reached, we suspect that this would leave Walgreen vulnerable to demands for lower pricing from other PBMs. While Walgreen may be able to get along without Express Scripts, it would be disastrous for the company to lose a second large PBM such as Medco, which puts Walgreen in a difficult negotiating position.

We believe the recent disputes between Walgreen and the PBMs are indicative of a larger trend of increasing hostility between payors (such as government agencies, managed-care organizations, and pharmacy benefit managers) and health-care providers (such as doctors, hospitals, and pharmacies). Due to a combination of health reform and the economy, regulators and businesses are now more focused on health-care costs than they have been in decades. Payors have an incentive to curb cost growth, while providers generally want to maximize their own revenue. The outcome of this fight could determine both the future rate of growth in health-care spending and the relative competitive advantages of payors and providers.

Also underlying the greater animosity is consolidation in the PBM industry, which has given the leading companies unprecedented bargaining leverage. Express Scripts' bargaining power could be greatly enhanced if the company's recently announced acquisition of Medco receives regulatory approval. Additionally, with the approaching peak of the generics wave, PBMs are being forced to consider new methods to create savings for clients, including tighter management of pharmacy networks. Finally, we see an increasingly competitive pharmacy marketplace. Patients now have more cheap and easy options for filling prescriptions, including nontraditional dispensing outlets such as mail-order, Wal-mart (WMT), and other diversified retailers.

The ultimate impact of the Walgreen-Express Scripts dispute on our fair value estimates will depend on how the disagreement is resolved. If a new contract can be agreed on quickly, as occurred with Walgreen and CVS Caremark, we are likely to maintain all fair value estimates. On the other hand, if an agreement is not reached before the end of the year, we are likely to lower our fair value estimate for Walgreen, perhaps significantly. The extent to which we lower our fair value estimate for Express Scripts will depend on how many clients, if any, the company loses as a result of not having Walgreen in its network.

The real winners from this dispute are competitor PBMs Medco (assuming its acquisition by Express Scripts falls through) and CVS Caremark. These companies stand to gain in two ways. First, they could gain bargaining leverage over Walgreen, which will likely be desperate not to lose a second large PBM. Second, they could steal PBM market share from Express Scripts.

Looking at the big picture, payors' increasingly aggressive stance toward reimbursements is a potential negative for all health-care providers, particularly those that lack scale. Walgreen is better positioned than most to stand up to the PBMs because of its large market share. Smaller pharmacy chains like Rite Aid (RAD) have much weaker bargaining positions.