

A GLIMPSE INSIDE DIPLOMAT PHARMACY'S INITIAL PUBLIC OFFERING: IMPLICATIONS FOR THE INDUSTRY

In a rocking stock market that covets investment opportunities in health care, the past two weeks have produced a string of headline grabbing deals involving publicly traded health care services providers.

First, there was the American Addictions Centers [AAC] initial public offering (IPO) that debuted on the NYSE on October 2nd, 2014, that quickly surged from an initial pricing of \$15.00 per share to \$19.00 by the end of the first week of trading – a gain of nearly 27%. For more details, see The Braff Group's recently published marketALERT analyzing AAC's IPO.

Next was the announcement on October 9th of the merger of Gentiva Health Services [GTIV] with Kindred Healthcare [KND], combining one of the nation's largest providers of home health care (Gentiva) with one of the leaders in residential skilled nursing and other post-acute services (Kindred) in a deal valued at \$1.8 billion.

On a smaller scale, though no less meaningful, was the announcement of the merger of MergeWorthRx [MWRX], a special purposes acquisition company, with AeroCare Holdings, a \$150M provider of home respiratory services, a transaction which "will provide the post-merger company with additional capital as well as public company currency to enhance and expand its organic growth initiatives and for future strategic transactions."

Finally, we have the initial public offering of Flint, Michigan based Diplomat Pharmacy, Inc., the nation's largest independent specialty pharmacy, with go-forward revenues of more than \$2 billion. Through the IPO, the company raised approximately \$130 million (before underwriting discounts and offering expenses), and is now the only pure-play, publicly traded, specialty pharmacy services provider. Under the ticker symbol DPLO, the company began trading on the NYSE on October 10th, 2014.

Below is our analysis of the Diplomat offering¹, and what it may mean for the specialty pharmacy services industry.

Share Pricing

Pricing an IPO is a delicate balancing act, price it too low and you short change the seller. But if you price it too high, such that demand is weak or prices fall as active trading begins (known

as a "Broken IPO"), you silence the all-important post-IPO buzz that draws investors clamoring to get in on the action. Not to be taken lightly, in a logic defying stock market where trading is more about chasing and riding momentum than innate risk-return fundamentals, generating gains on the first few trading days can prime the Wall Street apparatus that can keep a stock juiced for days and weeks to come.

In the case of Diplomat, while the IPO was a success, the underwriters **may** have been a bit "cautious."

Although it was originally expected to price between \$14.00 and \$16.00 per share, the offering was set at \$13.00 on Thursday, October 9th. When trading commenced Friday morning, it opened at \$16.00, rose as high as \$17.75 (a near 37% surge), and ended the day at \$16.02, 23% above the offering price. From the perspective of generating interest in the stock – mission accomplished, especially when you consider that the underwriters chose to exercise their over-allotment option and sell 2,000,000 additional shares – and the stock rose to \$18.81 with the announcement. The question, then, is whether or not they could have generated more cash and still realized similar market gains had they priced even at the bottom of the original \$14.00 - \$16.00 range (a sentiment that may have prompted *24/7 Wall St.* to opine, "Diplomat Turns **Bunt Pricing** [emphasis added] Into Homerun for IPO Buyers"). We'll leave that discussion to the pundit class. Suffice to say however, that with the downside of a "Broken IPO" far outweighing the upside of an additional \$10M raise (especially for a company valued at nearly \$800,000,000 six months ago²), we understand the call.

Valuation Metrics. The post-IPO valuation metrics for Diplomat are robust, to say the least.

When trading opened at \$16.00 per share, the imputed Enterprise Value³ was approximately 25.7 x 2013 EBITDA and 21.7 x June, 2014, annualized results.

Just a week later, with a closing price of \$18.81, the metrics surged to more than 30.0 x 2013 EBITDA, and 25.7 x annualized June 2014 EBITDA, and an Enterprise Value of approximately \$900,000,000.

This is particularly notable when you consider the pending acquisition of Salveo Specialty Pharmacy, a specialty Rx provider that

“manages approximately \$400M in annual drug spend” by Catamaran Corp, “a leading provider of technology and pharmacy benefit management services.” Announced in a press release just a day before Diplomat’s public offering, Catamaran reported that they paid “approximately 13 x Salveo’s trailing 12 month EBITDA” – a heady multiple for a company founded just three years ago – and notably higher than the average metric of 9.5 x EBITDA that Diplomat paid for two recently completed acquisitions with combined revenues of more than \$110M (more on this below). While a direct comparison between Diplomat and Salveo is flawed, it does begin to size up the premium that the market bestows to size and infrastructure. Given the high dollar nature of specialty pharmacy, size premiums do not begin to kick in until revenues approach \$100M or more. At this stage, the premium drives multiples to plus/minus 10x (as seen in Diplomat’s pre-IPO deal making). With revenues approaching \$500M, Salveo earned an additional three turns of EBITDA. And, for a provider (Diplomat) with \$2 billion in revenues, an infrastructure to support it, and a track record of nearly 30 years, the premium rises further yet.

An Abundance of Arbitrage

One of the primary goals of an acquisition and consolidation strategy is to capture higher valuation multiples on exit simply because of the increased value accorded to larger companies. It makes sense. The larger the company, the greater the operating, technology, marketing, and human resource infrastructure, the more diversified the revenues and referral bases, the greater the opportunity to access debt capital, the greater the purchasing power, and, ultimately, the greater the likelihood of sustained success that stems from these, and other, competitive advantages. So when you aggregate smaller acquisitions (or start-ups) that command lower multiples (or investment), you can realize substantial arbitrage, or “multiple expansion” (as the Wall Street types like to call it) when it’s time to sell or complete a public offering.

The big question, then, is how much arbitrage a market sector can generate?

Well, if the Diplomat deal is any indication, there is multiple expansion a plenty.

In the simplest of terms, consider that based on the company’s registration filings, Diplomat recently acquired two companies with a combined \$110M in revenues and approximately \$8.6M

in EBITDA for a combined price of nearly \$82M. A price that corresponds to a multiple of about 9.5 x. Consider further that the largest of the transactions, which accounted for more than 70% of the total, was financed, in part, with pre-IPO stock issued at \$16.64 per share just three months ago – a price clearly substantiated by current trading. That means that at the time, Diplomat paid 9.5x EBITDA for earnings they estimated that, when combined with the “mother ship,” would fetch a value of 22.6 x EBITDA, yielding multiple expansion of more than 13 x earnings. Essentially, then, that also means that **when Diplomat made the deals for \$82M, they increased the value of the firm by a whopping \$194M (22.6 x \$8.6M in acquired EBITDA), an instant gain of \$112M. Arbitrage, indeed.**

The after effect of all this arbitrage?

Private equity has long been drawn to specialty pharmacy, with its opportunity for rapid growth, and more to come as new therapies make their way through the development pipeline. With visions of Diplomat-like valuations coming into focus, we expect another fevered round of activity as new PE sponsors seek a toehold in specialty Rx. What’s more, it’s likely we will see consolidation among the PE sponsors themselves in an attempt to quickly ramp up to a billion or more in revenues and ride the burgeoning wave of enthusiasm. And inspired by a rocking stock market that welcomed Diplomat with open arms – and open wallets – we would be surprised if we didn’t see other firms go the IPO route, not only to realize a flood of liquidity, but to create currency in the form of company stock that can be deployed to finance the next round of deals.

So what does this all mean if you’re still a few years away from a sale?

Well, in short, it’s probably worth **at least considering** an accelerated exit strategy. Because a market built on moving billions of dollars of newly issued, often wildly expensive, therapies (that are like cat-nip to product liability attorneys and reflexively naysaying insurers and other payors), at gross profit margins of only 5-6%, can be one litigation, one manufacturer’s price hike, one high profile reimbursement cut, or even one competing therapeutic intervention away from valuation metrics that are arguably a more sober reflection of the industry’s risk profile.

Something to think about while all the confetti begins to settle.

¹ Disclaimer (to keep our lawyers happy): The calculations presented herein are based upon the aggregation and interpretation of data presented in the S-1 filing submitted by Diplomat Pharmacy, as well as press releases issued by other reputable third parties. In some cases, where information was unclear or unavailable, we made estimates based upon the sources cited as well as our best and reasoned understanding of the information as presented. While it is possible that our numbers may differ somewhat from others’ analyses, including Diplomat’s, we are confident that they are accurate both directionally and in terms of magnitude, providing a sound foundation for our interpretation of both the IPO and its potential impact on the go-forward investment climate for specialty pharmacy. This notwithstanding, our analysis should not be used for evaluating the purchase of these or other securities, nor should it serve as the factual basis for any other purpose.

² Based upon a share price set at \$16.74 for two private offerings and a recent acquisition

³ Enterprise Value is calculated by multiplying shares outstanding x share price – cash + long term debt

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