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We have just completed an analysis of the Medco 10-K for the fiscal year that ended December 25, 2004. A copy of our analysis is attached. In reviewing the document, we've made a number of observations that we want to share with our clients and colleagues. We do so with the caveat that these are our own observations, which should be viewed accordingly. We also emphasize that this is done solely on our behalf and that we are not speaking for any of our clients.

1. Medco is, to our knowledge, the only publicly traded PBM to disclose its rebate metrics, which makes this report particularly useful. It is our guess that Medco is obligated to disclose these rebates pursuant to the settlement of some litigation.
2. The rebates they received during this fiscal year are very substantial – in excess of \$3 billion!
3. Even with this disclosure, Medco managed to keep 44% of the rebates – about \$1.3 billion.
4. They also report 'service' revenues from drug manufacturers of almost \$180 million – which are not shared with clients!
5. We believe that Medco's share of rebates will continue to erode, as health plan sponsors slowly come to the realization that their PBM's profits are so huge!
6. Medco is doing a good job of promoting generics. An aficionado like me understands that this is done selfishly, since Medco makes so much on mail order generics and on the price spread for retail generic claims. But the results are evident and we understand why Medco's clients are pleased, since higher generic usage saves them a great deal. What they don't seem to understand is how much their PBM gains in the process.
7. Rebates can best be understood when calculated on a per-brand-claim basis, since rebate dollars drop as generic utilization increases. For this fiscal year, Medco received rebates of over \$11 per brand claim! This translates into over \$8 per brand claim, when the claim count is adjusted for mail Vs retail. [In that calculation, each mail order claim is treated as three retail claims.] The size of these rebates is a good insight into the negotiating power of PBMs, the three largest of which literally

control half the retail Rx's in the USA, and that share will grow when Medicare Part D starts next year!

8. Rebate revenue needs to be seen in the context of the higher generic usage, since there are no rebates on generics.
9. The revenue numbers are worth discussing. Medco, like most PBMs, show top-line revenue. This is permitted under accounting rules, so long as the PBM has a business risk. [Note that this is not an insurance risk!] Accordingly, Medco calculates its gross margin as a percentage of this top line revenue, which is about 5%. However, if the gross margin is calculated as a percentage of service revenue, the number is almost 250%. So how can the margin exceed the service fees? There are at least three reasons:
 - First, about 38% of their revenue comes from their mail order operations, which are a separate profit center;
 - Second, Medco, like most PBMs, adds a markup on what it pays the pharmacies in its retail network. In effect, it buys at one price, but sells at another. This is called 'spread', and is the justification for reporting top-line revenue. Medco claims that it informs its customers that it utilizes this practice, but we feel that most health plan sponsors are unaware of it.
 - Finally, as described above, Medco makes a huge profit on the share of money from drug companies that it does not share with its customers.

10. PBMs like Medco often allege that their mail order operations enable higher rebates. It is instructive to look at the verbiage in their 10-K:

“Rebate contracts with pharmaceutical manufacturers of brand-name drugs are negotiated on an enterprise-wide level based on our consolidated retail and mail order prescription volumes. We believe the level of rebates we are able to negotiate significantly benefits from our substantial mail order volume because we are able to achieve a higher level of formulary compliance in mail order than in retail. As a result, although the rebate contracts generate rebates on retail and mail order prescriptions equally on the basis of drug cost, it is not practicable to determine the true value of rebates earned specifically on retail or mail order prescription volume.”

It is our belief that, if community pharmacies had appropriate incentives, they could match mail order formulary compliance performance.

11. Mail order continues to grow. Medco's mail order sales grew by over \$2 billion, as compared with the prior year – largely attributed to the mandatory mail programs. This self-dealing is truly remarkable, since such relationships are prohibited almost everywhere else in health care. Medco views their PBM services and mail order operations are part of the same segment. Here is the relevant language from page 27 of their 10-K:

“We conduct our operations in one segment, which involves sales of prescription drugs to our clients and their members, either through our networks of contractually affiliated retail pharmacies or by our mail order pharmacies, and in one geographic region which includes the United States and Puerto Rico. We offer fully integrated PBM services to virtually all of our clients and their members. The PBM services we provide to our clients are generally delivered and managed under a single contract for each client.... As a result of the nature of our integrated PBM services and contracts, the chief operating decision maker views Medco as a single segment enterprise for purposes of making decisions about resource allocations and in assessing our performance.”

12. Gross margin per claim is \$3.43. It increased almost 17%, from \$2.88 last year. We believe this is largely due to the \$2 billion growth in mail order, which is hugely profitable.

13. Earning per claim, before taxes were \$1.60

14. Medco reported that, as part of its spin-off from Merck, it entered into a long term agreement to promote Merck products. Here's the language from page 32:

“In connection with the spin-off, we entered into a managed care agreement with Merck. The managed care agreement includes terms related to market share performance levels, formulary access rebates and market share rebates payable by Merck, as well as other provisions, including liquidated damages.”

Details of the Merck agreement are also described on page 50 of the 10-K.

This report has a wealth of useful information. I urge the reader to review our spreadsheet on the next page, and to obtain and review the entire Medco Annual Report.

In closing, we hope that you will find this report useful. We want to reiterate that these comments are ours alone and are based on our interpretation of the information in the Medco 10-K. Please feel free to contact us with any questions or comments.

Medco Fiscal Year Comparisons (\$ in millions)					
Revenue	12/25/2004	PCT Revenue	12/27/2003	PCT Revenue	PCT change
Product	\$35,024.4	99.07%	\$33,913.1	98.97%	3.17%
Retail	\$21,632.3	61.19%	\$22,661.1	66.14%	-4.76%
Mail	\$13,392.1	37.88%	\$11,252.0	32.84%	15.98%
Copays	\$ 6,773	19.16%	\$ 6,850	19.99%	-1.14%
Service revenue	\$ 327.5	0.93%	\$ 351.4	1.03%	-7.30%
Manufacturer services	\$ 179.7	0.51%	\$ 198.5	0.58%	-10.46%
Service	\$ 147.8	0.42%	\$ 152.9	0.45%	-3.45%
Total net revenue	\$35,351.9		\$34,264.5		3.08%
Margin Analysis					
Net Product Revenues	\$33,496.6		\$32,552.7		2.82%
Service Revenue	\$ 132.8		\$ 189.7		-42.85%
Cost of Revenue	\$33,629.4	95.1%	\$32,742.4	95.6%	
Gross Margin	\$ 1,722.5		\$ 1,522.1		11.63%
Gross Margin per claim	\$ 3.43		\$ 2.86		16.47%
EBITDA	\$ 806.3		\$ 728.7		9.62%
EBITDA per claim	\$ 1.60		\$ 1.37		14.57%
Operational Statistics					
Mail Order as % Sales	38.2%		33.2%		
Mail Order as % Claims	38.8%		34.0%		
Generic %	46.3%		43.8%		
Gross Margin %, as reported	4.9%		4.4%		
Gross Margin %, based on service revenue	246.2%		207.4%		
Volume of Claims (in millions)					
Retail	415.2		453.9		-8.53%
Mail	87.7		78.1		12.29%
Total	503		532		-5.47%
Adjusted [each mail claim = 3 retail]	678		688		-1.44%
Rebates					
		% total rebates			
Rebates Received by Medco from Drug Manufacturers	\$ 3,005		\$ 2,970		
Formulary rebates	\$ 1,421	47.3%	\$ 1,610	54.2%	
Non-formulary rebates	\$ 1,584		\$ 1,360		
Rebates retained by Medco	\$ 1,325	44.1%	\$ 1,592		53.6%
Rebates received per adjusted claim	\$ 4.43		\$ 4.32		2.7%
Retained rebates per adjusted Rx	\$ 1.95		\$ 2.31		-15.5%
Rebates received per brand Rx -- unadjusted	\$ 11.13		\$ 9.93		12.0%
Rebates received per adjusted brand claim	\$ 8.25		\$ 7.68		7.4%
Per Claim Statistics					
Average Copay	\$ 13.47		\$ 12.88		
Administrative fees per retail Rx	\$ 0.36		\$ 0.34		
Avg Retail Rx	\$ 52.10		\$ 49.93		
Avg Mail Rx	\$ 152.70		\$ 144.07		

