February 15, 2018

Diplomat Pharmacy: DPLO

Peter Galante

Sector: Healthcare
Industry: Healthcare Services
Current Price: $24.10
Target Price: $29.27

Diplomat Pharmacy, Inc. operates as an independent specialty pharmacy in the United States. The company stocks, dispenses, and distributes prescriptions for various biotechnology and specialty pharmaceutical manufacturers. Diplomat recently acquired full service, middle market pharmaceutical benefit manager capabilities.

BUY

Current Price:	$24.10
Target Price:	$29.27
Market Cap:	1.76B
Beta:	1.06
D/E:	16.32%
ROIC:	8.4%
WACC:	9.4%
TTM Cash EBITDA Margin:	2.2%

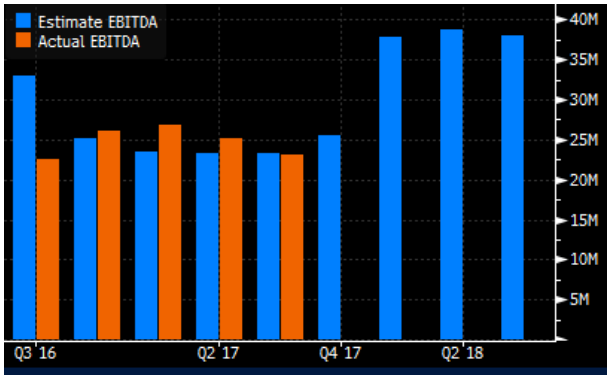
Thesis: Diplomat is underpriced in the market. With guidance offered for FY2018 EBITDA, the market has priced the stock lower than what these numbers suggest. Growth should continue for DPLO into the future as they realize synergies between their Spec Pharma Segment and their newly acquired PBM segment.

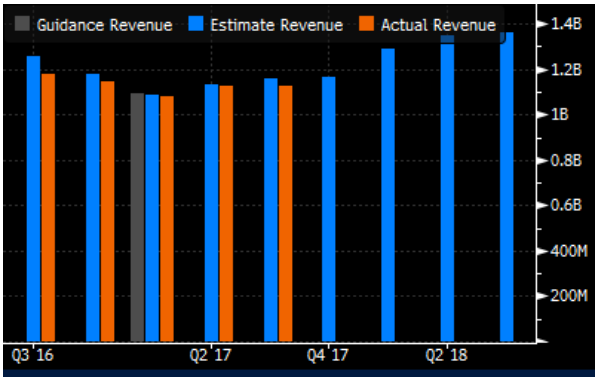
Catalysts:

- **Short Term:** The market is pricing future EBITDA at a lower margin than guidance suggests.
- **Medium Term:** Development of PBM segment to diversify EBITDA. The new management team has PBM experience, and synergies with Specialty Pharmacy should be realized.
- **Long Term:** Specialty pharmacy industry trends. Bundled PBM and Specialty pharmacy services should make Diplomat an attractive option for middle market customers.

Earnings Performance:

Diplomat has been subject to share price volatility around their earnings release. After Q3 2016, they reported revenue that was slightly below estimates, but missed consensus EBITDA by over $10 million. This began a period where about 25% of their revenue was exposed to Direct and Indirect Remuneration Fees. There is a later section that goes deeper into these fees. Diplomat is still subject to these fees from their PBM contracts, and in the quarters since they were introduced EBITDA margin was down to the 1-2% range.





For 2017 earnings, management emphasized that their dip in revenue and miss of the estimates came from the loss of two major contracts. Management explained that these were contracts where the customer was happy with the Specialty Pharmacy service that Diplomat was providing, but they decided to pursue a contract with a PBM that has it's own Specialty Pharmacy. PBMs that can provide bundled services were a major threat to Diplomat in the past. Revenue and EBITDA guidance for 2018 is optimistic, with growth in both coming from the acquisition of PBM services for Diplomat. Diplomat has focused on increasing internal accounting controls since their DIR Scandal in 2016. Since replacing their CFO, Diplomat has reported results more consistent with estimates.

Segment Analysis:

Diplomat now has multiple operating segments. For the vast majority of Diplomats existence, they have operated exclusively as an independent specialty pharmacy. They are the largest independent specialty pharmacy in the United States, with around 4% of the total market share. The three largest specialty pharmacies (Owned by CVS, Express Scripts, and Walgreens) make up around 60% of the market. For Diplomat, specialty pharmacy includes the distribution, and infusion services of specialty drugs. Specialty drugs are defined as high cost, high intensity, highly complicated and often drugs with limited availability. In the last twelve months the EBITDA margin for this segment was around 2.11%.

Diplomat's recent acquisitions in the PBM space met negative market reactions. Many analysts felt they overpaid for the two companies, and they utilized $96 Million in common stock between the two deals. The larger transaction, LDI ($595 million) was purchased at a multiple of 14.5x 2017 EBITDA. Diplomat expects both LDI and NPS to be accretive and synergy creating acquisitions. Combining the two companies EBITDA and Revenue for 2017 gives an estimated segment margin of 11.04%.

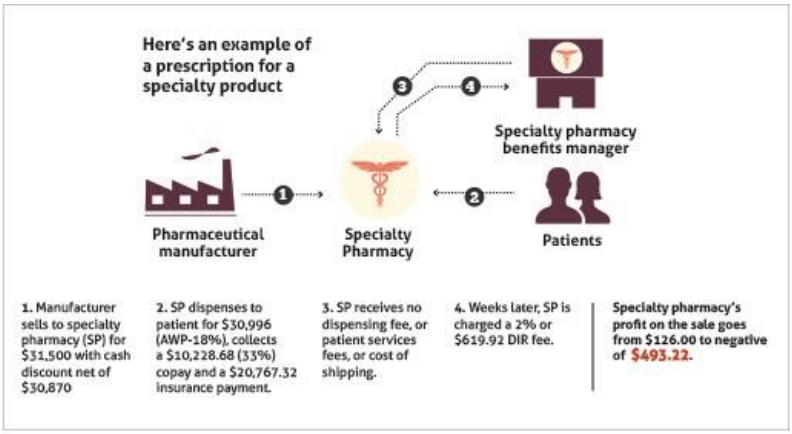
Diplomat also acquired hub service capabilities in the past. This is a very small segment, where the company acts as a relationship managing resource for drugs in the pipeline. This small segment has a 14.67% EBITDA margin.

EBITDA Margin Comparison - Distribution Segment	
DPLO	2.20%
McKesson	2.30%
Amerisource Bergen	1.30%
Cardinal Health	2.30%
EBITDA Margin Comparison - PBM Segment	
DPLO (NPS)	16.80%
DPLO (LDI)	10.60%
ESRX	7.50%
CVS (pbm)	4.50%
Optum Rx	5%

These are comparable companies or company segments to Diplomat's operations. Diplomat's distribution is consistent with similar companies. Their PBM additions have higher margins than other PBMs. Diplomat will seek out a different market than these three PBMs listed above. Diplomat is looking to provide highly customized service to middle market customers. The other PBMs that it can be compared to are focused on serving larger plans with a more uniform service provided.

DIR Visibility:

One of the major issues that the market had with the DIR fee scandal was that management was unclear on how these fees were assessed. Quarter after quarter, they were unable to explain how they were getting billed. Questions raising concerns over this have been a large portion of their earnings calls for the recent quarters, and there is finally improvement on this front. Diplomat is negotiating new contracts with CVS's PBM service. In addition to this, management has announced that they have increased their visibility on how the fees are assessed, and that the fees should remain more stable moving forward. The increased visibility and more reliable accounting should relieve some of the downward pressure that Diplomat's share price is under.



Adapted from The Wall Street Journal.

Acquisition of PBM Segment:

As previously mentioned, Diplomat's main threat when it came to customer retention and winning new contracts was bundled service offerings from PBMs with Specialty Pharmacy capabilities. LDI and NPS give Diplomat access to 855k covered lives from over 700 unique customers. Diplomat is used to providing highly specialized service for their distribution business, and they plan on bringing this high touch approach to the PBM market.

With around 25% of distribution revenue exposed to DIR fees, these PBMs will diversify the EBITDA of the company. A higher margin segment will work to improve margins, and the ability to bundle services will allow Diplomat to take advantage of industry trends. The two PBMs together mean that Diplomat will be able to offer full service to customers, and they are complementary products.

NPS TRANSACTION SUMMARY

NPS National Pharmaceutical Services®

Target	• Pharmaceutical Technologies, Inc., dba National Pharmaceutical Services (NPS) • Full-service pharmacy benefit manager (PBM) with access to 475,000 member lives • Based in Omaha, Nebraska • Revenue: $32 million (2017E) and Adjusted EBITDA: $5.4 million (2017E)
Purchase Price	• $47 million purchase price • Transaction includes real estate valued at ~$10 million
Consideration	• $31 million in cash using cash on hand and existing credit facility • $16 million in common stock • No contingent earn-out consideration • Expected to be accretive to adjusted EPS in 2018
Business Overview	• Diversified mix of PBM lives • Robust technology platform: In-house proprietary claims-processing system • Captive mail-order pharmacy (Integrated HMO Pharmacy) • Near-term synergy opportunities for specialty Rx volume • Senior management team will remain in place
Closing	• Diplomat announced closing of the acquisition of NPS Nov. 29, 2017.

LDI TRANSACTION SUMMARY

LDI integrated pharmacy services Health Solutions Made Personal

Target	• LDI Integrated Pharmacy Services ("LDI") • Full-service PBM with 2017E revenue of $388 million and 2017E adjusted EBITDA of $41 million

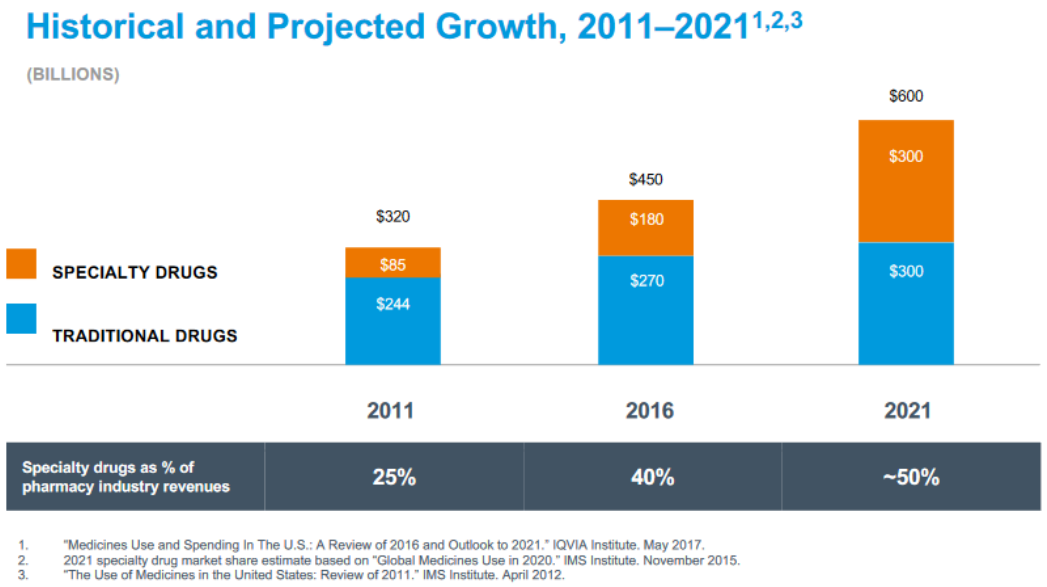
Purchase Price	• $595 million gross purchase price
	  - Represents ~14.5x on gross purchase price
	• $540 million adjusted purchase price
	  - ~$94 million tax shield (NPV ~$55 million)
	  - Represents ~13.2x post tax shield benefit
	• $4-6 million of synergies in Year 1
	  - Represents ~11.7x post synergies and post tax shield

Consideration	• $515 million in cash - Committed cash financing from a new $795 million credit facility provided by JPMorgan and Capital One • ~$80 million in common stock, representing ~4.15 million shares • Pro forma total leverage of ~4.6x LTM adjusted 2017 EBITDA; Expected to be between 2.0x-3.0x by mid 2019 • Expected to be accretive to adjusted EPS in 2018
Closing	• Diplomat announced closing of the acquisition of LDI Dec. 20, 2017.

Diplomat's interim CEO has held many positions in the PBM space. He joins two other former Catamaran employees in the management team. Diplomat has built a team that will be successful in integrating and growing the new segment. Former CEO and Co-Founder Phil Hagerman has left Diplomat in a position to grow sustainably while improving profitability.

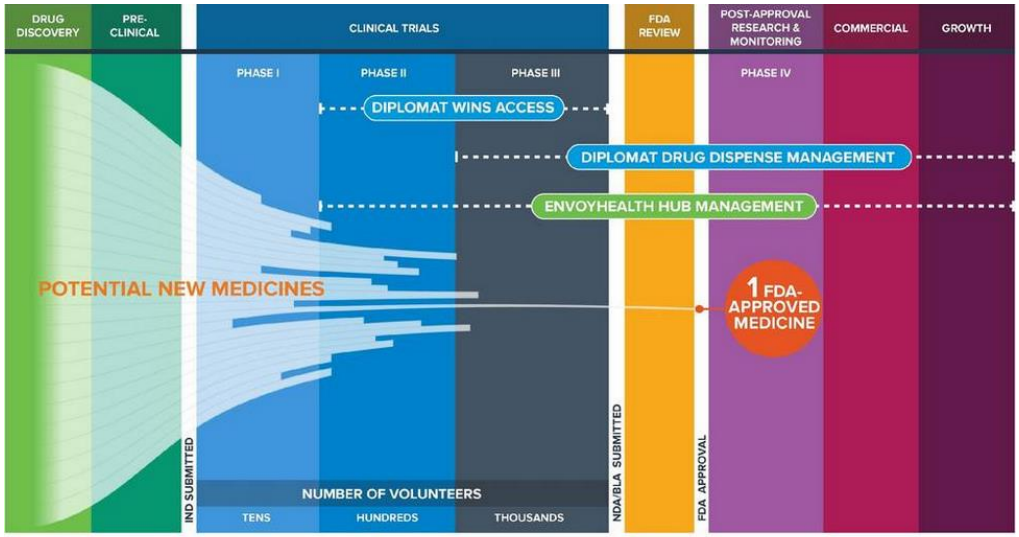
Industry Outlook:

Specialty pharmacy is projected to grow at a rapid rate. In 2016 Specialty Pharmacy represented 40% of the pharmaceutical industry spend at $180 million. By 2021, it is expected to be approaching 50% of the total spend, at over $300 million. This increasing portion of the pharmaceutical spend is spent on 1% of covered employees.



1. "Medicines Use and Spending In The U.S.: A Review of 2016 and Outlook to 2021." IQVIA Institute. May 2017.
2. 2021 specialty drug market share estimate based on "Global Medicines Use in 2020." IMS Institute. November 2015.
3. "The Use of Medicines in the United States: Review of 2011." IMS Institute. April 2012.

Oncology drugs represent the largest portion of the specialty pipeline. This is an optimistic trend for Diplomat, as they have historically been successful in winning oncology contracts. With hub services offerings through their acquisition of Envoy health, and now the capability to offer bundled PBM/Specialty Pharmacy Services, Diplomat has never been in a better position to win contracts.



Key: IND: Investigational New Drug Application, NDA: New Drug Application, BLA: Biologics License Application

Proprietary and Confidential of Diplomat Pharmacy Inc.

Diplomat now has the capability to offer services from the earliest stage possible all the way through to approval and continued market growth.

Valuation:

The market is currently undervaluing Diplomat based on 2018 guidance. The market seems to be pricing in an EBITDA margin of 2.65-2.75%. Based on 2018 guidance, EBITDA should be expected to be in the range of 2.9-3.2%. This gives a 1 year target price of $29.

Guidance estimates were that revenue could range from $5.3-$5.6 Billion and EBITDA could range from $164-$170 Billion. This is approximately a 66% increase from 2017 to 2018 EBITDA.

In a pessimistic case where EBITDA margin sees no improvements, and revenue growth is lower by 1% in each year of the explicit period than in the base case, the price target is $17.41.

In an optimistic case, where EBITDA increases to 3.2% in the base year and stays at that level, and revenue growth is constant with the base case, the one year target price is $33.51

Conclusion:

Diplomat Pharmacy has never been in a better position to win contracts than they are now. With full service middle market PBM offerings, and top quality Specialty Pharmacy distribution, Diplomat will take advantage of strong industry growth trends through new the bundled service offerings that customers are demanding. Their new management team has success in the PBM market, and the integration of the new segment is expected to be accretive to earnings and synergistic. In addition to growth prospects and margin

improvements, I believe that Diplomat is currently undervalued in the market based on 2018 guidance. I recommend Diplomat Pharmacy as a buy.

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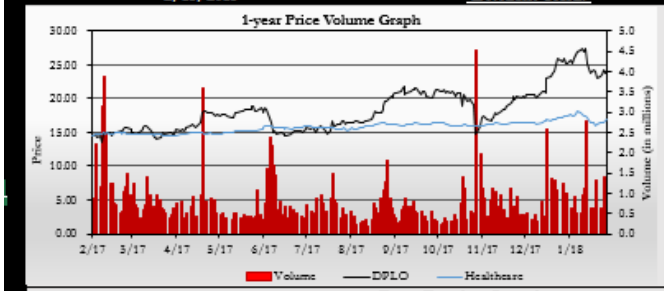
Diplomat Pharmacy, Inc. (DPLO)

CENTER FOR GLOBAL FINANCIAL STUDIES

BULLISH

Analysis by Peter Galante	Current Price:	$24.10	Intrinsic Value	$26.34	Target 1 year Return: 21.43%
2/18/2018	Divident Yield:	0.0%	Target Price	$29.27	Probability of Price Increase: 100%



Description

Diplomat Pharmacy, Inc. operates as an independent specialty pharmacy in the United States.

General Information

Sector	Healthcare
Industry	Healthcare Providers and Services
Last Guidance	February 12, 2018
Next earnings date	February 27, 2018

Market Assumptions

Estimated Equity Risk Premium	5.69%
Effective Tax rate	21%

Market Data

Market Capitalization	$1,758.17
Daily volume (mil)	0.61
Shares outstanding (mil)	72.95
Diluted shares outstanding (mil)	68.18
% shares held by institutions	109%
% shares held by investments Managers	56%
% shares held by hedge funds	2%
% shares held by insiders	27.68%
Short interest	11.06%
Days to cover short interest	9.88
52 week high	$27.78
52-week low	$13.39
Volatility	0.00%

Past Earning Surprises

Quarter ending	Revenue	EBITDA
9/30/2016	-6.49%	-40.94%
12/31/2016	-1.47%	-18.73%
3/31/2017	-0.56%	4.52%
6/30/2017	-0.49%	-5.94%
9/30/2017	-2.19%	-10.30%
Mean	**-2.24%**	**-14.28%**
Standard error	1.0%	4.4%

Market and Credit Scores

Recommendation (STARS) Value--0

Recommendation (STARS) Description--0

Quality Ranking Value--0

Quality Ranking Description--0

Short Score--3

Market Signal Probability of Default % (Non-Ratings)--0.334%

CreditModel Score (Non-Ratings)--bb-

Industry and Segment Information

LTN Revenues by Geographic Segm	LTM Revenues by Business Segments
United States--100%	Specialty Pharmacy Services--100%
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Peers

Express Scripts Holding Company	--
Premier, Inc.	--
Walgreens Boots Alliance, Inc.	--
CVS Health Corporation	--
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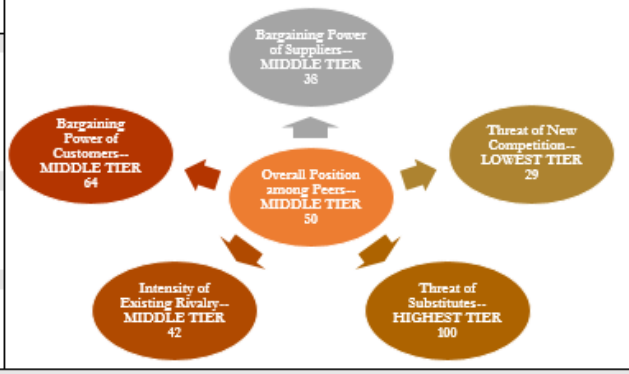
Management	Position	Total Compensations Grow	Stock Price Growth During Tenure
Hagerman, Philip	Co-Founder & Chairman Emeritus	59.65% per annum over 3y	
Rice, Gary	Executive Officer		0% per annum over 0y
Park, Jeffrey	Interim CEO & Director		
Saban, Joel	President		
Kavthekar, Atul	Chief Financial Officer and Treasurer		
Brown, Stephen	Chief Information Officer		

Profitability	DPLO (LTM)	DPLO Historical	Peers' Median (LTM)
Return on Capital (GAAP)	8.4%	7.10%	2.56%
Operating Margin	2%	1.33%	11.00%
Revenue/Capital (GAAP)	4.74	5.35	0.23
ROE (GAAP)	2.0%	9.2%	13.7%
Net margin	0.3%	0.5%	3.4%
Revenue/Book Value (GAAP)	7.74	18.18	4.04
Invested Funds	**DPLO (LTM)**	**DPLO Historical**	**Peers' Median (LTM)**
Cash/Capital	3.0%	2.3%	1.9%
NWC/Capital	20.3%	21.1%	-4.3%
Operating Assets/Capital	27.6%	62.6%	71.8%
Goodwill/Capital	49.2%	14.0%	30.6%
Capital Structure	**DPLO (LTM)**	**DPLO Historical**	**Peers' Median (LTM)**
Total Debt/Market Capitalization	0.21	0.17	0.34
Cost of Debt	5.2%	4.7%	4.6%
CGFS Rating (F-score, Z-score, and default Probal	BBB		
WACC	8.1%	10.4%	8.4%

Porter's 5 forces (Scores are percentiles)



Valuation

Forecast Assumptions	Explicit Period (6 years)	Continuing Period
Revenue Growth CAGR	9%	2%
Average Operating Margin	3%	4%
Average Net Margin	2%	3%
Growth in Capital CAGR	10%	2%
Growth in Claims CAGR	2%	2%
Average Return on Capital	10%	11%
Average Return on Equity	11%	11%
Average Cost of Capital	9%	10%
Average Cost of EquityKe	11%	11%