Express Scripts Holding Co.
Form 10-Q
October 25, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2016.

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ____________ to _____________.
Commission File Number: 1-35490

EXPRESS SCRIPTS HOLDING COMPANY
(Exact name of registrant as specified in its charter)

Delaware	45-2884094
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
One Express Way, St. Louis, MO	63121
(Address of principal executive offices)	(Zip Code)

Registrant’s telephone number, including area code: (314) 996-0900

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer	Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company)	Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Common stock outstanding as of September 30, 2016: 616,621,000 Shares

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements
EXPRESS SCRIPTS HOLDING COMPANY
Unaudited Consolidated Balance Sheet

(in millions)	September 30, 2016	December 31, 2015
Assets		
Current assets:		
Cash and cash equivalents	$ 2,304.7	$ 3,186.3
Receivables, net	6,967.0	6,721.3
Inventories	1,677.4	2,023.1
Prepaid expenses and other current assets	173.9	128.8
Total current assets	11,123.0	12,059.5
Property and equipment, net	1,255.5	1,291.3
Goodwill	29,278.3	29,277.3
Other intangible assets, net	9,099.1	10,469.7
Other assets	153.4	145.5
Total assets	$ 50,909.3	$ 53,243.3
Liabilities and stockholders' equity		
Current liabilities:		
Claims and rebates payable	$ 8,717.1	$ 9,397.7
Accounts payable	3,791.1	3,451.8
Accrued expenses	2,286.3	2,659.4
Current maturities of long-term debt	1,184.0	1,646.4
Total current liabilities	15,978.5	17,155.3
Long-term debt	14,924.5	13,946.3
Deferred taxes	3,734.8	4,069.8
Other liabilities	662.5	691.4
Total liabilities	35,300.3	35,862.8
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Preferred stock, 15.0 shares authorized, $0.01 par value per share; no shares issued and outstanding	—	—
Common stock, 2,985.0 shares authorized, $0.01 par value; shares issued: 856.8 and 854.5, respectively; shares outstanding: 616.6 and 676.9, respectively	8.6	8.5
Additional paid-in capital	23,175.7	22,204.7
Accumulated other comprehensive loss	(9.6)	(14.0)
Retained earnings	10,366.5	8,396.8
	33,541.2	30,596.0
Common stock in treasury at cost, 240.2 and 177.6 shares, respectively	(17,940.9)	(13,223.2)
Total Express Scripts stockholders' equity	15,600.3	17,372.8
Non-controlling interest	8.7	7.7
Total stockholders' equity	15,609.0	17,380.5
Total liabilities and stockholders' equity	$ 50,909.3	$ 53,243.3

See accompanying Notes to Unaudited Consolidated Financial Statements

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EXPRESS SCRIPTS HOLDING COMPANY
Unaudited Consolidated Statement of Operations

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in millions, except per share data)	2016	2015	2016	2015
Revenues[1]	$25,410.1	$25,222.6	$75,424.2	$75,576.4
Cost of revenues[1]	23,136.0	23,049.1	69,141.9	69,437.7
Gross profit	2,274.1	2,173.5	6,282.3	6,138.7
Selling, general and administrative	858.1	1,007.3	2,669.2	3,013.2
Operating income	1,416.0	1,166.2	3,613.1	3,125.5
Other (expense) income:				
Interest income and other	8.3	7.8	27.4	19.1
Interest expense and other	(273.4)	(128.4)	(548.8)	(377.1)
	(265.1)	(120.6)	(521.4)	(358.0)
Income before income taxes	1,150.9	1,045.6	3,091.7	2,767.5
Provision for income taxes	422.4	378.2	1,103.9	1,046.9
Net income	728.5	667.4	1,987.8	1,720.6
Less: Net income attributable to non-controlling interest	5.6	5.7	18.1	17.7
Net income attributable to Express Scripts	$722.9	$661.7	$1,969.7	$1,702.9
Weighted-average number of common shares outstanding during the period:				
Basic	622.6	676.3	632.9	693.1
Diluted	627.1	682.2	637.4	699.5
Earnings per share:				
Basic	$1.16	$0.98	$3.11	$2.46
Diluted	$1.15	$0.97	$3.09	$2.43

1 Includes retail pharmacy co-payments of $2,008.5 million and $2,161.5 million for the three months ended September 30, 2016 and 2015, respectively, and $6,685.9 million and $7,118.2 million for the nine months ended September 30, 2016 and 2015, respectively.

See accompanying Notes to Unaudited Consolidated Financial Statements

EXPRESS SCRIPTS HOLDING COMPANY
Unaudited Consolidated Statement of Comprehensive Income

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in millions)	2016	2015	2016	2015
Net income	$728.5	$667.4	$1,987.8	$1,720.6
Other comprehensive income (loss):				
Foreign currency translation adjustment	(1.7)	(7.3)	4.4	(12.8)
Comprehensive income	726.8	660.1	1,992.2	1,707.8
Less: Comprehensive income attributable to non-controlling interest	5.6	5.7	18.1	17.7
Comprehensive income attributable to Express Scripts	$721.2	$654.4	$1,974.1	$1,690.1

See accompanying Notes to Unaudited Consolidated Financial Statements

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EXPRESS SCRIPTS HOLDING COMPANY
Unaudited Consolidated Statement of Changes in Stockholders' Equity

	Number of Shares	Amount						
(in millions)	Common Stock	Common Stock	Additional Paid-in Capital	Accumulated Other Comprehensive Loss	Retained Earnings	Treasury Stock	Non-controlling Interest	Total
Balance at December 31, 2015	854.5	$8.5	$22,204.7	$ (14.0)	$8,396.8	$(13,223.2)	$ 7.7	$17,380.5
Net income	—	—	—	—	1,969.7	—	18.1	1,987.8
Other comprehensive income	—	—	—	4.4	—	—	—	4.4
Treasury stock acquired	—	—	825.0	—	—	(4,717.7)	—	(3,892.7)
Changes in stockholders' equity related to employee stock plans	2.3	0.1	146.0	—	—	—	—	146.1
Distributions to non-controlling interest	—	—	—	—	—	—	(17.1)	(17.1)
Balance at September 30, 2016	856.8	$8.6	$23,175.7	$ (9.6)	$10,366.5	$(17,940.9)	$ 8.7	$15,609.0

See accompanying Notes to Unaudited Consolidated Financial Statements

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EXPRESS SCRIPTS HOLDING COMPANY
Unaudited Consolidated Statement of Cash Flows

	Nine Months Ended September 30,					
(in millions)	2016			2015		
Cash flows from operating activities:						
Net income	$	1,987.8		$	1,720.6	
Adjustments to reconcile net income to net cash provided by operating activities:						
Depreciation and amortization	1,611.2			1,727.7		
Deferred income taxes	(334.0		)	(270.5		)
Employee stock-based compensation expense	81.9			86.8		
Other, net	(19.1		)	(45.3		)
Changes in operating assets and liabilities:						
Accounts receivable	(270.7		)	(1,468.7		)
Inventories	345.7			382.7		
Other current and noncurrent assets	(43.5		)	(139.7		)
Claims and rebates payable	(680.7		)	250.4		
Accounts payable	348.0			172.2		
Accrued expenses	(327.4		)	(425.0		)
Other current and noncurrent liabilities	(28.7		)	(16.9		)
Net cash flows provided by operating activities	2,670.5			1,974.3		
Cash flows from investing activities:						
Purchases of property and equipment	(237.6		)	(177.1		)
Other, net	(7.6		)	19.2		
Net cash used in investing activities	(245.2		)	(157.9		)
Cash flows from financing activities:						
Proceeds from long-term debt, net of discounts	5,986.8			5,500.0		
Repayment of long-term debt	(5,395.0		)	(3,353.3		)
Treasury stock acquired	(3,892.7		)	(5,500.0		)
	56.0			155.0		

Net proceeds from employee stock plans						
Excess tax benefit relating to employee stock-based compensation	11.1			53.0		
Other, net	(75.7		)	(58.8		)
Net cash used in financing activities	(3,309.5		)	(3,204.1		)
Effect of foreign currency translation adjustment	2.6			(6.7		)
Net decrease in cash and cash equivalents	(881.6		)	(1,394.4		)
Cash and cash equivalents at beginning of period	3,186.3			1,832.6		
Cash and cash equivalents at end of period	$	2,304.7		$	438.2	

See accompanying Notes to Unaudited Consolidated Financial Statements

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EXPRESS SCRIPTS HOLDING COMPANY
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
Note 1 - Summary of significant accounting policies
Our significant accounting policies, normally included in financial statements prepared in conformity with generally accepted accounting principles, have been omitted from this Form 10-Q pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). We believe the disclosures contained in this Form 10-Q are adequate to fairly state the information when read in conjunction with the Notes to the Consolidated Financial Statements included in our 2015 Annual Financial Statements for the year ended December 31, 2015, included in Item 8 - Consolidated Financial Statements and Supplementary Data for the year ended December 31, 2015, included on Form 10-K filed with the SEC on February 16, 2016. For a description of our accounting policies, refer to the Notes to the Consolidated Financial Statements included therein.
We believe the accompanying unaudited consolidated financial statements reflect all adjustments (consisting of only normal recurring adjustments) necessary to state fairly the unaudited consolidated balance sheet as of September 30, 2016, the consolidated balance sheet as of December 31, 2015, the unaudited consolidated statement of operations and unaudited consolidated statement of comprehensive income for the three and nine months ended September 30, 2016 and 2015, the unaudited consolidated statement of changes in stockholders' equity for the nine months ended September 30, 2016, and the unaudited consolidated statement of cash flows for the nine months ended September 30, 2016 and 2015. Certain amounts in the prior year have been reclassified to conform to the current year presentation. Operating results for the three and nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016.
New accounting guidance. In August 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-15, Statement of Cash Flows (Topic 230), Classification of Certain Cash Receipts and Cash Payments. The guidance addresses the classification of cash flow related to (1) debt prepayment or extinguishment costs, (2) settlement of zero-coupon debt instruments or other debt instruments with coupon rates that are insignificant in relation to the effective interest rate of the borrowing, (3) contingent consideration payments made after a business combination, (4) proceeds from the settlement of insurance claims, (5) proceeds from the settlement of corporate-owned life insurance, including bank-owned life insurance, (6) distributions received from equity method investees and (7) beneficial interests in securitization transactions. The guidance also clarifies how the predominance principle should be applied when cash receipts and cash payments have aspects of more than one class of cash flows. The guidance will generally be applied retrospectively and is effective for financial statements issued for annual reporting periods beginning after December 15, 2017. Early application is permitted. We are currently evaluating the impact of this standard on our consolidated statement of cash flows.
In March 2016, FASB issued ASU 2016-09, Improvements to Employee Share-Based Payment Accounting, which amends Accounting Standards Codification ("ASC") Topic 718, Compensation – Stock Compensation. The new standard simplifies the accounting for stock-based compensation, including amendments on how both taxes related to stock-based compensation and cash payments made to taxing authorities are recorded. These amendments are expected to impact net income, earnings per share ("EPS") and the consolidated statement of cash flows. The new guidance is effective for financial statements issued for annual reporting periods beginning after December 15, 2016, and early application is permitted, with any adjustments reflected as of the beginning of the fiscal year of adoption. We are currently evaluating the impact of this standard on our consolidated financial statements.
In February 2016, FASB issued ASU 2016-02, Leases (ASC Topic 842), which supersedes ASC Topic 840, Leases. This ASU is intended to increase transparency and comparability of organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The new guidance is effective for financial statements issued for annual reporting periods beginning after December 15, 2018, and early application is permitted. We are currently evaluating the impact of this standard on our consolidated financial statements.
In May 2014, FASB issued ASU 2014-09, Revenue from Contracts with Customers (ASC Topic 606), which supersedes ASC Topic 605, Revenue Recognition. The new standard requires companies to recognize revenues upon transfer of goods or services to customers in amounts that reflect the consideration which the company expects to

receive in exchange for those goods or services. In July 2015, the FASB delayed the effective date of the standard by one year. The new guidance is effective for financial statements issued for annual reporting periods beginning after December 15, 2017, and early application is not permitted before the original effective date of annual reporting periods beginning after December 15, 2016. We are currently evaluating the impact of this standard on our consolidated financial statements.

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Note 2 - Fair value measurements

Authoritative guidance regarding fair value measurement establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets for identical assets or liabilities; Level 2, defined as inputs other than quoted prices for similar assets and liabilities in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs for which little or no market data exists, therefore requiring an entity to develop its own assumptions.

The fair values of cash and cash equivalents and investments (Level 1), accounts receivable, claims and rebates payable and accounts payable approximate carrying values due to the short-term maturities of these instruments.

Financial assets accounted for at fair value on a recurring basis include cash equivalents of $1,644.6 million and $1,795.5 million and trading securities (included in other assets and consisting primarily of mutual funds) of $29.5 million and $26.8 million as of September 30, 2016 and December 31, 2015, respectively. These assets are carried at fair value based on quoted prices in active markets for identical securities (Level 1). Cash equivalents include investments in AAA-rated money market mutual funds with original maturities of less than 90 days.

The fair values, which approximate the carrying values, of our 2015 two-year term loan and 2015 five-year term loan (Level 2) (as defined in Note 5 - Financing) were estimated using the current market rates for debt with similar maturities. The fair values of our senior notes are $13,695.0 million and $11,078.0 million as of September 30, 2016 and December 31, 2015, respectively. See Note 5 - Financing for further discussion of the carrying values of our debt. The fair values of our senior notes were estimated based on observable market information (Level 2). In determining the fair values of liabilities, we took into consideration the risk of nonperformance. Nonperformance risk refers to the risk the obligation will not be fulfilled and affects the value at which the liability would be transferred to a market participant. This risk did not have a material impact on the fair values of our liabilities.

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Note 3 - Goodwill and other intangible assets

Following is a summary of our goodwill and other intangible assets for our two reportable segments, Pharmacy Benefit Management ("PBM") and Other Business Operations.

(in millions)	September 30, 2016 Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	December 31, 2015 Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Goodwill						
PBM	$29,287.8	$ (106.9)	$29,180.9	$29,286.7	$ (106.8)	$29,179.9
Other Business Operations	97.4	—	97.4	97.4	—	97.4
	$29,385.2	$ (106.9)	$29,278.3	$29,384.1	$ (106.8)	$29,277.3
Other intangible assets						
PBM						
Customer contracts	$17,570.7	$ (8,629.9)	$8,940.8	$17,570.3	$ (7,290.0)	$10,280.3
Trade names	226.6	(100.3)	126.3	226.6	(83.6)	143.0
Miscellaneous	8.7	(7.8)	0.9	8.7	(6.5)	2.2
	17,806.0	(8,738.0)	9,068.0	17,805.6	(7,380.1)	10,425.5
Other Business Operations						
Customer relationships	107.5	(95.9)	11.6	120.1	(98.1)	22.0
Trade names	35.7	(16.2)	19.5	35.7	(13.5)	22.2
	143.2	(112.1)	31.1	155.8	(111.6)	44.2
Total other intangible assets	$17,949.2	$ (8,850.1)	$9,099.1	$17,961.4	$ (7,491.7)	$10,469.7

Following is a summary of the change in the net carrying value of goodwill by reportable segment:

(in millions)	PBM	Other Business Operations	Total
Balance at December 31, 2015	$29,179.9	$ 97.4	$29,277.3
Foreign currency translation	1.0	—	1.0
Balance at September 30, 2016	$29,180.9	$ 97.4	$29,278.3

The aggregate amount of amortization expense of other intangible assets was $463.7 million and $432.9 million for the three months ended September 30, 2016 and 2015, respectively, and $1,370.7 million and $1,298.3 million for the nine months ended September 30, 2016 and 2015, respectively.

Included in total amortization expense is $55.4 million and $23.8 million for the three months ended September 30, 2016 and 2015, respectively, and $145.1 million and $71.4 million for the nine months ended September 30, 2016 and 2015, respectively, related to our 10-year contract with Anthem, Inc. ("Anthem") to provide PBM services to members of the affiliated health plans of Anthem, which amounts are included as an offset to revenues. When we executed our agreement with Anthem in 2009, we considered the overall structure of the agreement and the nature of our relationship with Anthem, including the complexity of the service level required, and attributed a reasonable likelihood of renewal at the end of its term in 2019. Accordingly, we amortized the agreement using a modified pattern of benefit over an estimated useful life of 15 years. However, due to the sequence of events regarding our discussions with Anthem, culminating in the filing of a lawsuit by Anthem on March 21, 2016, we felt it prudent to consider the increased likelihood of either non-renewal or renewal on substantially different terms such that, beginning in March 2016, we began amortizing our agreement with Anthem over the remaining term of the contract (i.e., using a life of 10 years from the time the agreement was executed in 2009). Previously, we amortized the agreement over 15 years. Therefore, the intangible asset amortization associated with the Anthem agreement will run through the remaining term of the contract at the end of 2019, reducing the previous amortization period by 5 years. This change increased intangible asset amortization by $10.5 million for the first quarter of 2016 and by approximately $32.0 million per quarter beginning in the second quarter of 2016.

The weighted-average amortization period of intangible assets subject to amortization is 15 years, and by major intangible asset class is 8 to 20 years for customer-related intangible assets, 10 years for trade names (excluding legacy Express Scripts, Inc. ("ESI") trade names which have an indefinite life) and 5 years for other intangible assets.

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Following is a summary of the annual expected aggregate amortization of other intangible assets (in millions):

Year Ended December 31,	Future Amortization
2016	$ 1,833.0
2017	1,446.0
2018	1,436.0