Analysts can't agree on Caremark deal

By Walker Duncan

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With yesterday's news that Caremark Rx was being acquired by CVS came a flurry of anaylst opinions on the matter this morning. So far, the market has shown a general distaste for the transaction with both stocks dropping on massive trading volumes.

While most of the analysts chalk the trading frenzy up to short-term overreaction, most of them, even the ones who are generally optimistic about the deal, have their reservations. And in fact some of them can't even agree whether or not this deal makes any sense at all. *NashvillePost.com* reviewed a number of analyst reports today, most of which carry a tone of guarded optimism, but some display sentiments more of disbelief and outrage.

One such report came from Bank of America Securities analyst Bob Willoughby, whose immediate reaction to news of a possible Caremark-CVS merger, as reported in *NashvillePost.com* **yesterday**, was to dismiss the report as unlikely to be true because such a deal would make little sense.

The first line of Willoughby's report today states, in large red letters "It’s Not Enough! Shareholders Won’t Vote for Vision." The report goes on to say that B of A does not see the strategic advantage of the deal and that, in fact, the deal will likely create opportunities for Caremark's compeititors to take business from the new consolidated company.

Willoughby is not at all alone in his concern or even his shock over the share price Caremark accepted in the deal. As it currently stands, the transaction would give Caremark a price of approximately $48 per share. As Andrew L. Speller of AG Edwards notes in his report, "this is a far cry from our previous expectation of a $55-$60 per share possible buyout price."

Some were less shocked. Daivd Trainer of the Nashville-based value-investment specialist firm New Constructs, told *NashvillePost.com* about bogeys outside the balance sheet that mainstream equity analysts have tended to overlook when computing Caremark's real worth. Trainer says the company carries $273 million in off-balance sheet debt and $381 million in stock option liabilities for past grants. And he notes that "option grants have historically taken 400 basis points out of their profit margin," amounting to roughly another $422 million in future liability when looked at as the "perpetuity value of the $40 million in option

expense this year assuming a 9 percent cost of capital."

Take such factors into account, Trainer says, and "the stock looks fairly valued at $48.50." That said, he commented, "most companies do not sell out for fair value. They usually sell for a premium. From that perspective, I can see why investment banking firms might scream that they could help CMX management fetch a better price."

In general, the group view was that the price was too low. And the concerns that echoed thoughout the reports mostly seemed due to the cut-rate price juxtaposed with the plucky optimisim of firm leaders Mac Crawford and Tom Ryan, which was hard to read and left many questions unanswered.

As an example, Tom Gallucci of Merrill Lynch wondered "why the company would repurchase its own stock in the $50s, but agree to a transaction that currently left stock in the $40s?" During the third quarter of '06, Caremark repurchased 1.8 million shares at a total cost of $102.4 million.

Other analysts were wary of the assertion, made by both CEOs, that this move was in no way a defensive one. The price led Speller to wonder "whether CMX was anticipating problems on the horizon... and needed an exit strategy, thus justifying the lower valuation."

Other concerns included those over the CVS/Caremark's general viability. "We think it's worth pointing out that retail pharmacies did own large PBMs in the 1990's and that the combination did not work well at the time," said Matt Perry of Wachovia in his report, where he downgraded Caremark. He went on to say that "the independent PBM model has historically worked best because it did not have any conflict with wanting to shift demand to retail to drive store traffic."

However, despite concerns over the price tag or the transaction itself, most of the analysts were confident in the combined entity's ability to make money over the long term. Constantine Davides of Susquehanna Financial Group stated: "There is no question that following integration, the combined entity would be unmatched in either the retail chain or PBM industry."

Michael Baker of Raymond James agrees, stating that "CVS's move 'trumps' Wal-Mart's generic efforts, in our opinion, as it strikes at the core of pharmacy spend – the employer's wallet." But even with that strong optimism, Baker also believes the price seems low. "We are surprised that CVS did not have to pay more of a premium to acquire a stronger position in the pharmaceutical channel," his report says.

Clearly the jury is still out on this deal, which is expected to close in the next 6-12 months. Analysts and shareholders may be slightly crestfallen over the bargain price for Caremark, but many seem to think the new entity will be successful in the long term.

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