

## Hidden in plain view

Back in 2018, Cigna announced a bid for Express Scripts, changing the profile of the insurance business. Now roughly half of the combined entity comprises “legacy” Cigna which is a United States based health insurer. The majority of Cigna’s products are offered through employers. The other half of the business is represented by healthcare services which comprises the old Express Scripts business alongside a speciality pharmacy and nursing provider and online doctors’ services.

Express Scripts was a pharmacy benefit manager (PBM) which helps to manage the costs of paying for healthcare on behalf of insurers or employers. This is done by creating lists of drugs that insurers are willing to pay for and negotiating discounts for these drugs using the combined buying power of multiple clients.

After the 2018 deal was announced, the stock dropped precipitously, partially as a result of technical pressure from risk arbitrageurs and also as many long-term shareholders disliked the deal. Over the years, there has been a lot of negative sentiment politically surrounding PBMs and whether they have a role in the high cost of drugs in the US. This goes some way towards explaining the negative reaction from Cigna shareholders when the deal was originally announced.

In contrast, we believed at the time that the deal was actually good for shareholders. Management provided guidance of accretion in the mid-teens over the first year, and the medium-term opportunity for cost synergies and cross selling had the potential to accelerate growth further for the combined business. Despite the reservations of the market relating to the process of combining these businesses, the company remained a growing, highly profitable, cash generating machine which was trading at an exceptionally compelling valuation. Whilst we recognise the risk, we must also acknowledge the central role that PBMs play in the American healthcare system. Without a complete reform of the entire system from the ground up, we’ve always believed that these companies are here to stay.

Since the deal completed, the company has performed very well operationally, achieving our expectations of low to mid double digit EPS growth. The healthcare services division’s revenue growth has accelerated by benefitting from the anticipated cross selling opportunities. Cost synergies have also helped to contribute to EPS growth in the mid-teens.

Going forward, Cigna’s long-term EPS growth within a range of 10-13% p.a. should remain intact. Notwithstanding this, the stock trades at a relatively modest 10x forward P/E multiple. Moreover, Cigna’s earnings are of the highest quality. The company generated more free cash flow than it reports as earnings and this can be deployed into share buybacks and dividends.

The company is currently out of favour once again, even relative to other insurance peers, for two reasons. Firstly, loss ratios have been running higher than normal this year during the re-opening of the economy. Last year they were lower than normal during the Covid-related shutdowns. Whilst this is negative in the short-term, policies are re-priced every year and so we anticipate that Cigna should be able to pass on these costs in the next year which means that margins should recover. ►►

Secondly, with the Democrats having control of both the House and the Senate, political and regulatory concerns have raised their heads again. Any shift away from employer-sponsored healthcare towards government-sponsored programs would be negative for Cigna relative to peers. However, we do not believe that it is the intention of President Biden to stop employer subsidised healthcare and increase the cost burden on government in the process. The lack of action on this during the Obama-Biden administration also suggests that he is not supportive. In addition, with his wafer-thin majority, it seems extremely unlikely that he would risk something so controversial.

Given these factors, and considering the expected potential return as compared to the risk as outlined, Cigna remains one of our highest conviction names and we have taken the opportunity to add it to the DGP portfolio. Sometimes there can be a perception that value investing involves hunting in obscure parts of the market for undiscovered hidden gems. However, often the best investments are well known quality companies which are temporarily out of favour. Cigna certainly fits in this box in our view. ■

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