Specialty Pharmacy Solutions - **Client Alert** - 11/03/2016

Diplomat Financials Offer insights into SP Market Challenges ©

There are relatively few publicly traded specialty pharmacies nationally…. but only one that is closest to a 'pure play specialty', Diplomat. The others are subsidiaries of PBMs, or other multi-business-line corporations that do not disclose the granular financial performance of their subsidiaries…. so we rarely see the full picture of how only their specialty pharmacy performed.

Diplomat just released their 3rd quarter financials and they showed that operating a specialty pharmacy in today's marketplace 'ain't' easy.
Now Diplomat is a very well run organization with significant bulk (revenue, operations, acquisitions, manufacturer LD contracts, etc.)…. so, if they are finding it increasingly difficult to reach year-over-year growth forecasts, what does that mean for smaller specialty pharmacies with much less leverage?

Here are some stats that other specialty pharmacies may want to use as benchmarks --- (*these are third quarter results so yearend will be more telling*):

- Revenue increase of 25% / 12% organic revenue growth
- Total prescriptions increase of 9%
- Gross margin of 6.6%
- SG&A 6.1% (*other financial elements, as detailed below, explain the difference between Gross Margin and EBITDA contribution*)
- Adjusted EBITDA margin of 1.9% (*versus 3.5% last year*)
- Gross profit per prescription dispensed of $289, compared to $301 (*remember that Diplomat is heavily weighted to very expensive Oncology and other LD drugs*)

Overall, those are numbers that most smaller specialty pharmacies would love to be booking….. unless you have to appease Wall Street's insatiable appetite for bigger and better numbers --- ad infinitum. *As to the other big players, we have to presume that they, too, are feeling the same marketplace pressures in specialty pharmacy*.

The press release cited a **significant** negative impact related to DIR fees. We covered this topic last month (*refer to Client Alert on 9/16 "Are DIR Fees Diluting Pharmacy Reimbursements?"*). One paragraph from that Alert says it all…… "…**DIR fees can total thousands of dollars each month and make it impossible to determine at the time of dispensing whether the net reimbursement will cover costs, such as purchasing drugs." These fees are 'clawed back' sometimes months after a product is dispensed. Now that is a huge problem since margin erosion is a big concern that every specialty pharmacy has had to deal with**."
If you want to read a quick article on DIR FAQs check out http://www.pharmacytimes.com/contributor/blair-thielemier-pharmd/2016/07/the-dirt-on-dir-fees

Hang in there Diplomat…… we're rooting for ya…… especially if you can help resolve the DIR fee problem!

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Diplomat Announces 3rd Quarter Financial Results

3rd Quarter Revenue Increased 25%
Direct and Indirect Remuneration ("DIR") Fees Negatively Impact Profit

FLINT, Mich., Nov. 2, 2016 /PRNewswire/ -- Diplomat Pharmacy, Inc. (NYSE: DPLO), the nation's largest independent specialty pharmacy, announced financial results for the quarter ended September 30, 2016. All comparisons, unless otherwise noted, are to the quarter ended September 30, 2015.

Third Quarter 2016 Highlights include:

- Revenue of $1,181 million, an increase of 25% or $234 million
  - 12% organic revenue growth
- Total prescriptions dispensed of 266,000, an increase of 9%
- Gross margin of 6.6% versus 8.0%
  - Gross profit per prescription dispensed of $289, compared to $301
- Net income attributable to Diplomat of $5.4 million, a decrease of $10.6 million
- Adjusted EBITDA of $22.6 million, a decrease of $10.4 million
  - Adjusted EBITDA margin of 1.9% versus 3.5%
- EPS of $0.08 per diluted common share versus $0.24
  - Adjusted EPS of $0.21 versus $0.27
- Third quarter revenue and profit measures, compared to the year ago period, were negatively impacted by an incremental $8 million of DIR fees, of which $4 million was retroactive to Q1 and Q2 2016

Phil Hagerman, CEO and Chairman of Diplomat, commented "We are disappointed with our third quarter results, which were significantly impacted by the softness in the hepatitis C business nationwide, as well as by **DIR fees**. The **methodology and transparency around how PBMs are applying these DIR fees changed materially in 2016**, and while we cannot reverse the impact they had on this quarter, we are working with our partners in the specialty pharmacy industry and with legislators to achieve an amicable solution to this problem."

"Despite the pressure we felt during the third quarter, our largest therapeutic category, oncology, continued to lead our growth. Driven by strong trends such as limited distribution, our oncology business increased 57% year over year, and 36% on an organic basis. We also have confidence in Diplomat's future prospects as we see continued growth in the robust drug development pipeline, a number of early wins from our strategy of marketing directly to payors and health plans, and our ability to make strategic acquisitions in the core specialty pharmacy industry, as well as in expanding complementary service areas."

Third Quarter Financial Summary:

Revenue for the third quarter of 2016 was $1,181 million, compared to $947 million in the third quarter of 2015, an increase of $234 million or 25%. The increase was the result of 12% organic revenue growth driven by approximately $79 million of revenue from drugs that were new in the past year and approximately $65 million from the impact of manufacturer price increases. Approximately $119 million of the increase was from our TNH Advanced Specialty Pharmacy ("TNH") acquisition. The organic growth was partially offset by approximately $8 million in incremental DIR fees and a shift in hepatitis C drug mix from those drugs that existed a year ago to new drugs. DIR fees is a term used by the Centers for Medicare and Medicaid Services ("CMS") to address price concessions that ultimately impact the prescription drug costs of Medicare Part D plans, but are not captured at the point of sale. This term is used to capture a number of a different type of fees assessed after adjudication of a claim.

Gross profit in the third quarter of 2016 was $78.5 million and generated a 6.6% gross margin, compared to $75.8 million and 8.0% in the third quarter of 2015. The gross margin decline in the quarter was primarily due to the impact of the incremental DIR fees, the non-repeat of a one-time approximately $3 million pharma incentive that was received in the year ago period, a continued shift in mix towards higher priced but lower percent margin drugs, including the impact of TNH, lower growth and lower margins in our specialty infusion business, and the September 2015 sale of our low profit, but high margin, compounding business.

Selling, general, and administrative expenses ("SG&A") for the third quarter of 2016 were $77.1 million, an increase of $28.3 million, compared to $48.9 million in the third quarter of 2015. Of this increase, $6.8 million related to employee cost, including employee cost from our acquired entity. The increased employee expense was primarily attributable to higher prescription dispensed volume, combined with the increased clinical and administrative complexity associated with our mix of both acquired and organic business. Also contributing to the increase was the non-repeat of a favorable $6.8 million Q3 2015 change in the fair value of contingent consideration associated with our acquisitions during Q3 2015. We also experienced a $4.8 million impairment expense to fully impair the definite-lived intangible assets associated with Primrose Healthcare, LLC ("Primrose"), a $4.4 million increase in bad debt expense, a $1.9 million increase in amortization expense from definite-lived intangible assets associated with our acquisitions, and increases in other SG&A to support our growth; including software licenses, insurance and other miscellaneous expenses. As a percentage of revenue, SG&A, excluding change in fair value of contingent consideration and the impairment of Primrose, was 6.1% for the three months ended September 30, 2016 compared to 5.9% in the prior year period. This increase is primarily attributable to the non-repeat of a $2.9 million bad debt expense credit in the prior year period, partially offset by natural leverage associated with managing high priced drugs.

Net income attributable to Diplomat for the third quarter of 2016 was $5.4 million versus $16.0 million in the third quarter of 2015, a decrease of $10.6 million. The decrease in net income was driven by the revenue, gross profit, and SG&A explanations above, partially offset by a $13.0 million improvement in income taxes. Adjusted EBITDA for the third quarter of 2016 was $22.6 million versus $33.0 million in the third quarter of 2015, a decrease of $10.4 million. This decrease resulted from the incremental DIR fees, and the non-repeat of the one-time pharma incentive and the bad debt expense credit both recognized in the year ago period.

Earnings per common share for the third quarter of 2016 was $0.08, compared to $0.25 per common share for the third quarter of 2015. On a diluted basis, earnings per share was $0.08 per common share in the third quarter of 2016, compared to $0.24 per common share in the prior year period. Diluted non-GAAP adjusted earnings per share ("Adjusted EPS") was $0.21 in the third quarter of this year compared to $0.27 in the third quarter of 2015. Compared to the year ago period, our diluted weighted average common shares outstanding in the third quarter of 2016 were approximately 4% higher, impacted by the use of shares as partial consideration for our TNH acquisition, as consideration for the BioRx LLC earn out, and stock option activity.

2016 Financial Outlook

For the full-year 2016, we are decreasing our previous financial guidance for revenue, adjusted EBITDA, and Adjusted EPS. Our guidance is as follows:

- Revenue between $4.4 and $4.6 billion, versus the previous range of $4.5 and $4.9 billion

- Adjusted EBITDA between $107 and $111 million, versus the previous range of $121 and $129 million
- Adjusted EPS between $0.83 and $0.87, versus the previous range of $0.90 to $0.95

Our Adjusted EPS expectations assume approximately 68,500,000 weighted average common shares outstanding on a diluted basis for the fourth quarter and a forty percent tax rate for the fourth quarter, which could differ materially.

Sully
Bill Sullivan
Principal Consultant
Specialty Pharmacy Solutions LLC
Phone: 781-929-4302
Fax: 781-394-7781

Total Specialty Rx Solutions