Ross School of Business at the University of Michigan

# Independent Study Project Report

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**TITLE** : **Chronimed, Inc. Financial Statement Analysis**

MBA

# Chronimed, Inc.

## Financial Statements Analysis

Professor Lundholm
Thursday, April 8,1999

Rob Eisenbach

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## Introduction

Founded in 1985, Chronimed is a small-cap health care company that started with a fairly unique business plan - being a one-stop shop for those with diabetes. The idea at the time was that through specialization in diabetes, the company could improve outcomes for its customers, enhance their quality of life, and better manage health care costs (these are the three points of the company's mission statement). As time passed, the company expanded its focus to additional chronic diseases, including organ transplant and HIV / AIDS patients, among others. Chronic diseases are extremely complex and extremely costly, as 45% of Americans suffer from chronic conditions that account for about 75% of U.S. health care spending. Specifically, Chronimed focuses on diseases that have average annual pharmaceutical costs of over $20,000 per patient.

In 1992, Chronimed went public and experienced rapid growth, with revenues almost tripling and profits almost quadrupling since fiscal 1994. Subsequently, the company was named one of Fortune's "100 Fastest-Growing Companies" in 1997 and 1998 (based on the earnings per share growth rate for the three previous years). The company was also named as one of Financial World's "100 Hottest Small Companies" in 1998. Refer to ***Exhibit 1*** for condensed Chronimed financial statements.

## Business Strategy Analysis

Chronimed's primary businesses are (1) a mail-order pharmacy for organ transplant patients and patients who use biotech injectibles, (2) a chain of retail pharmacies for HIV/AIDS patients, and (3) a manufacturer and distributor of diabetes test equipment. Further, Chronimed also distributes other companies' diabetes test equipment through its mail-order pharmacy, catalog, and sales force for institutional customers.

Chronimed's vision of providing quality health care services and products to chronically ill patients at competitive prices has remained relatively unchanged over the past 15 years; the only change has been an increased emphasis on cost control. The company's specialization in complex, chronic diseases allows it to be more familiar with its customers and their health risks, and, therefore, provide valuable consultation to patients and their doctors. Moreover, these customers use a great deal of high-cost pharmaceuticals and medical products over their entire lives, which provides the company with a stable, annuity-like revenue base from which to operate and grow. Chronimed's strategy also enhances patient retention and differentiates the company from its competitors.

The company emphasizes that its service provides a benefit to insurance companies and other payers, as it leads to lower long-term health care costs through improved drug compliance and overall better disease management. Unfortunately, the company has no proof of this advantage, as such a study would be prohibitively expensive and time-consuming, according to the company. Consequently, the company has not pursued this avenue. Accordingly, Chronimed has been unable to charge more for its services, as it must compete on price. Consequently, the company is under significant price pressure from bigger, less specialized competitors who have greater scale economies. In conclusion, while the company has many advantages, it will be difficult for the company to leverage these advantages into profits until it can either prove the value of these benefits or grow large enough that it can compete on scale.

## Accounting Analysis

Chronimed's accounting policies seem straightforward. For example, accounts receivables (A/R) for a company like Chronimed are somewhat at the whim of insurance agencies and other payers with respect to the amount and timing of payments. Measures of A/R management include an allowance for doubtful accounts, which has been holding steady at 5.2% over the past two years, and A/R as a percentage of sales, which has been declining: 21.9% in 1996, 17.4% in 1997, and 16.5% in 1998. This decline can be attributed to its "clean-up" of its A/R in 1997, which subsequently lowered both the allowance for doubtful accounts and the write-offs in 1998.

Because Chronimed has been actively growing through acquisition, goodwill is a significant part of its balance sheet, representing $16.3 million in 1998 (or 22% of total assets). Chronimed amortizes goodwill on a straight-line basis over two to 20 years, although its most recent acquisitions have been amortized over seven or 12 years. However, while these numbers seem reasonable, Chronimed provides no justification as to how they are chosen for any particular purchase. Thus, it is difficult to tell if the company uses goodwill as a significant earnings management lever.

Finally, Chronimed appears to have few "red flags" associated with its accounting methods and financial reporting. Based on our analysis, the following items represent potential "red flags":

- Chronimed's cash from operations (CFO) has been decreasing over the last three years and dropped significantly below net income for the first time in 1998. This drop is due to an increase in working capital assets, while paying down accounts payable.
- In 1997, Chronimed wrote-off $1.4 million for a loan to Health Craft International, Inc. (HCI) as a one-time charge. This money was loaned to HCI for the research and development of new diabetes monitoring technology. Since the technology was never proven viable, the loan was determined to be unrecoverable. Chronimed waited, however, to write-off this note until it had an unusual gain (a sale of distribution rights) to offset the loss. Since Chronimed does not have other loans of this nature, this issue may be minor, but the timing of the write-off may be indicative of earnings management.
- Chronimed expects no material effect due to the Year 2000 system problem, but it is very likely that they will be impacted by their payers, since the health care industry generally uses old, mainframe-based systems. While it is unclear how this issue will impact Chronimed, a short-term increase in its accounts receivable can be expected.

## Financial Analysis

We analyzed and benchmarked two companies against Chronimed's financial performance. The first company, CVS Corporation, the nation's second largest retail drug store chain, was selected because Chronimed also operates a small chain of retail pharmacy stores. The second company identified was Bergen Brunswig, a manufacturer of medical-surgical supplies to hospitals and managed care facilities. Chronimed similarly manufacturers medical supplies, such as blood glucose monitors, to managed care organizations and to patients directly.

Using the DuPont model to calculate the return on equity (ROE) for each company, CVS has the highest return (CVS 15.9%, Chronimed 13.4%, Bergen Brunswig .5%). Refer to *Exhibit 2* for the financial ratios of all three companies. Profit margins for all three companies are relatively low, as distributors get squeezed on price from the drug manufacturers and the payers (i.e., insurance companies). Distribution, in general, is characterized by small profit margins, especially in this industry. Looking forward, Chronimed has the opportunity to increase its profit margins by achieving scale efficiencies in manufacturing operations, continuing to build brand equity in its pharmacy business, and pushing its Diagnostic business unit's proprietary high-margin products.

The asset turnover ratio for all three companies increased between 1997 and 1998. For CVS and Chronimed, economies of scale in the number of retail stores and distribution centers have contributed to higher turnovers. Bergen Brunswig has the highest asset turnover and leverage since its primary business is medical supply manufacturing, which employs relatively few, but highly productivity machines. Chronimed can expect to increase its asset turnover as it grows and gains economies of scale from its distribution facilities.

Chronimed operates with very little leverage (1.22), as it virtually has no debt. In comparison, Bergen Brunswig's leverage ratio is 4.3, while CVS' is 2.7. Since its incorporation, Chronimed has used essentially no debt financing, since it has traditionally kept large reserves of cash on hand. A cash flow analysis shows that the company did not begin to spend the proceeds of its 1994 seasoned equity offering until 1996. As of 1997, the company still had $15.3 million in cash and investments - although this balance dropped to $7.5 million in 1998. This decrease was primarily due to several acquisitions and a stock repurchase program. Further, while leverage maybe the easiest aspect of the DuPont model to alter, Chronimed may wish to maintain its current level of leverage. However, if the company continues to pursue acquisitions at its current pace, it may become necessary for it to take on more debt and thus increase its leverage.

With regard to sustaining its ROE in the long-term, the company should be able to at least maintain its profit margin, while increasing asset turnover and leverage. However, this might not be the case in the short-term as Chronimed is under price pressures in its Specialty Pharmacy Services business. Additionally, Chronimed's ROE has yet to match or exceed its required cost of equity (approximately 14.9%) in any of the years studied. Thus, even if the company can maintain its current ROE, it will continue to destroy shareholder value unless it can improve upon its ROE. This goal, however, does seem attainable.

## Prospective Analysis

Utilizing the discounted abnormal earnings valuation model and our assumptions, we arrived at a value of about $11.49 per share of Chronimed, in contrast to the April 2, 1999 market close of $6,125. Refer to *Exhibits 3* and *4* for the full details of the model.

In using the abnormal earnings model, we undertook several steps. First, we determined the appropriate discount rate using the CAPM formula, with 5.25% as the risk-free rate, 7.2% as the market premium, and 1.34 as Chronimed's beta. Making these assumptions results in a required return on equity of 14.9% for the company.

Next, we estimated Chronimed's financial statements through 2005, with this last year serving as the first year of a non-growing perpetuity, which we used to calculate the terminal value. Given Chronimed's recent press release regarding lower than expected performance, we adjusted its operating margin down for 1999 (below last year's performance). We matched our 1999 earnings ($0.63) to the prevailing market forecast.

Given the company's historical rate of revenue growth of approximately 30% per year and its increasing asset turnover ratio (a projected ratio of 2.39 for 1999), we sought to keep sales growth high, but in balance with asset turnover. With that in mind, we projected 20% revenue growth for 2000, with following years' sales tied to the 2000 asset turnover number (kept constant at 2.58). We also believe that gross margins will return to historical levels of 30%, as the company grows its higher margin Diagnostic Products and Disease Management divisions. We have phased this increase in over four years, increasing gross margin 1% every two years. For SG&A, we believe that the company will improve its spending efficiencies (per recent company announcements), and have also phased in a 1% spending cut every two years, until SG&A falls to 19% of revenue.

In the base case, we have assumed that the leverage ratio will increase slightly - due to the company maintaining its growth rate, but depleting its available cash (as mentioned above). As a result, Chronimed can either finance this growth through expansion of its A/P (which has been shrinking) or through the issuance of debt (of which it currently has none).

Given the above assumptions, the indicated value per share of Chronimed is $11.49. This likely differs from the current market valuation due to the recent announcements made by Chronimed about short-term difficulties. A similar situation occurred in 1995, and the market responded in the similar fashion, before pushing the stock to all-time highs in 1996. In short, the market is very likely over-reacting to recent announcements by Chronimed, but will return to early-1999 levels of between $10 and $14. We feel that our estimates are reasonable given the company's historical performance and the current business environment and outlook. Further, if the company decides to make any significant change in its capital structure, it would easily support a price above the current market price. For sensitivities, we looked at the following:

- Keeping 1999 financial results as a perpetuity (for a result of $4.29 a share)
- Keeping 1999 financial results as a perpetuity, but undertaking a re-capitalization in 2000 to get a 2.0 leverage ratio ($7.35)
- Taking the base case assumptions, but a constant leverage ratio ($9.18)
- Taking the base case, but with the leveraged re-capitalization in 2000 ($15.60)

Clearly, the company can easily change its leverage ratio and increase its ROE and valuation. Thus, it makes sense to build this increased leverage into the forecast with the assumption that management will increase leverage in the future to increase shareholder return on equity. How much they will increase leverage is really the question. Clearly, management needs to ensure that any increase in leverage can be done without significantly decreasing its flexibility.

In summary, we believe that our P&L forecasts are reasonable and within historical performance, and our leverage forecasts are reasonable to conservative. Therefore, we recommend a "buy" for Chronimed since our base-case forecasts indicate modest performance improvements will yield a price nearly 90% above the current market valuation.

# Exhibit 1: Chronimed Financial Statements

Income Statement

| | Jul-98 | Jun-97 | Jun-96 | Jun-95 | .Tun-94 |
|---|---|---|---|---|---|
| Revenue | 140.7 | 117.2 | 90.5 | 62.5 | 49.0 |
| Cost of Goods Sold | 101.4 | 82.8 | 65.1 | 46.2 | 35.9 |
| Gross Profit | 39.3 | 34.4 | 25.4 | 16.3 | 13.1 |
| SG&A Expense | 28.9 | 25.5 | 18.3 | | |
| Operating Income | 10.4 | 8.9 | 7.1 | | |
| Non-Operating Income | 1.5 | 2.5 | 1.3 | | |
| Income Before Taxes | 11.9 | 11.4 | 8.4 | | |
| Income Taxes | 4.6 | 4.3 | 2.8 | | |
| Net Income | 7.2 | 7.0 | 5.5 | 1.6 | 2.0 |
| | | | | | |
| Earnings / Share | 0.59 | 0.56 | 0.42 | 0.13 | 0.18 |
| Book Value / Share | 5.14 | 4.24 | 4.40 | 3.86 | 3.86 |
| | | | | | |
| Gross Margin % | 27.9% | 29.4% | 28.1% | 26.1% | 26.7% |
| Pretax Margin % | 8.4% | 9.6% | 9.2% | 3.4% | 4.5% |
| Net Margin % | 5.1% | 6.0% | 6.0% | 2.6% | 4.1% |

**Balance Sheet**

| | Jul-98 | Jun-97 | Jun-96 |
|---|---|---|---|
| Cash | 1.0 | 5.0 | 11.4 |
| Net Receivables | 24.3 | 20.7 | 19.8 |
| Inventories | 10.9 | 7.9 | 5.5 |
| Other Current Assets | 7.6 | 11.5 | 13.9 |
| Total Current Assets | 43.7 | 45.1 | 50.7 |
| Net Fixed Assets | 13.0 | 7.5 | 5.4 |
| Other Non-Current Assets | 0.2 | 1.1 | 11.9 |
| Total Assets | 73.1 | 65.3 | 67.9 |
| | | | |
| Accounts Payable | 6.8 | 3.1 | 5.1 |
| Short-Term Debt | 0.0 | 0.4 | 0.4 |
| Other Current Liabilities | 3.8 | 7.8 | 5.0 |
| Total Current Liabilities | 10.6 | 11.3 | 10.4 |
| Long-Term Debt | 0.0 | 0.0 | 0.4 |
| Other Non-Current Liabilities | 0.0 | 0.0 | 0.0 |
| Total Liabilities | 10.8 | 12.0 | 10.9 |
| | | | |
| Common Stock Equity | 62.3 | 53.4 | 57.2 |
| Total Equity | 62.3 | 53.4 | 57.2 |
| Shares Outstanding (millions) | 12.1 | 11.9 | 12.5 |

Cash Flow **Statement**

| | Jul-98 | Jun-97 | Jun-96 |
|---|---|---|---|
| Net Cash from Operations | 5.4 | 8.5 | 9.6 |
| Net Cash from Investing | -10.3 | -1.8 | -2.3 |
| Net Cash from Financing | 0.8 | -13.2 | 1.9 |
| Net Change in Cash | -4.0 | -6.4 | 9.2 |
| Depreciation & Amortization | 4.0 | 3.5 | 1.8 |
| Capital Expenditures | -14.1 | -4.4 | -3.4 |

# Exhibit 2: Comparative Ratio Analysis

| | Chronimed | | | Bergen Brunswig | | | CVS Corp. | | |
|---|---|---|---|---|---|---|---|---|---|
| | Jul-98 | Jun-97 | Jun-96 | Sep-98 | Sep-97 | Sep-96 | Dec-98 | Dec-97 | Dec-96 |
| **DuPont Model** | | | | | | | | | |
| Profit Margin | 5.08% | 6.01% | | 0.02% | 0.70% | | 2.60% | 0.30% | |
| Asset Turnover Ratio | 2.15 | 1.73 | | 6.32 | 4.31 | | 2.26 | 1.95 | |
| Leverage Ratio | 1.22 | 1.19 | | 4.30 | 4.30 | | 2.71 | 2.99 | |
| Return on Equity | 13.40% | 12.31% | | 0.49% | 12.98% | | 15.92% | 1.73% | |
| x (1 - Dividend Payout Ratio) | 1.00 | 1.00 | | 0.70 | 0.70 | | 0.77 | 0.77 | |
| Sustainable Growth Rate | 13.40% | 12.31% | | 0.34% | 9.08% | | 12.26% | 1.33% | |
| **Profit Margin** | | | | | | | | | |
| Gross Profit/Sales (%) | 27.89% | 29.31% | 28.02% | 4.38% | 5.61% | 5.77% | 25.40% | 25.30% | 26.70% |
| SGA/Sales (%) | 19.62% | 19.70% | 18.62% | 3.12% | 4.11% | 4.21% | 19.31% | 20.22% | 21.24% |
| **Asset Turnover** | | | | | | | | | |
| Inventory Turnover | 9.3 | 10.5 | 11.8 | 11.2 | 8.4 | 7.7 | 3.6 | 3.5 | 3.9 |
| A/R Turnover | 6.1 | 5.8 | 4.6 | 17.9 | 15.1 | 14.9 | 23.5 | 28.2 | 34.4 |
| A/P Turnover | 14.8 | 15.4 | 12.8 | 10.4 | 8.2 | 7.5 | 8.9 | 8.1 | 8.0 |
| Working Capital Turnover | 4.3 | 3.5 | 2.3 | 29.0 | 22.0 | 22.6 | 13.1 | 15.3 | 7.0 |
| Current Asset Turnover | 3.2 | 2.6 | 1.8 | 6.8 | 5.4 | 5.1 | 3.5 | 3.5 | 2.8 |
| PP&E Turnover | 10.8 | 15.7 | 16.8 | 118.2 | 84.3 | 69.7 | 11.3 | 13.3 | 9.1 |
| **Financial Leverage** | | | | | | | | | |
| Current Ratio | 4.1 | 4.0 | 4.9 | 1.3 | 1.3 | 1.3 | 1.4 | 1.3 | 1.7 |
| Quick Ratio | 2.9 | 3.2 | 3.0 | 0.5 | 0.5 | 0.5 | 0.3 | 0.2 | 0.5 |
| Cash Ratio | 0.7 | 1.4 | 1.1 | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.4 |
| Operating Cash Flow Ratio | 0.5 | 0.8 | 0.9 | 0.0 | 0.0 | 0.1 | 0.1 | (0.1) | 0.1 |
| Liabilities-to-Equity Ratio | 0.2 | 0.2 | 0.2 | 3.8 | 3.2 | 3.3 | 1.2 | 1.4 | 1.3 |
| Debt-to-Equity Ratio | 0.0 | 0.0 | 0.0 | 0.7 | 0.6 | 0.7 | 0.3 | 0.3 | 0.2 |
| Price/Sales Ratio | 0.44 | | | 0.12 | | | 1.16 | | |
| Price/Book Ratio | 1.19 | | | 3.27 | | | 6.25 | | |
| Price/Earnings Ratio | 10.38 | | | 222.22 | | | 46.23 | | |

# Exhibit 3: Chronimed Forecasted Financials

| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|
| **Assumptions** | | | | | | | |
| Sales Growth | 175,000 | 20.0% | 20.9% | 22.4% | 20.9% | 24.3% | 25.2% |
| Gross Margin | 28.0% | 28.0% | 29.0% | 29.0% | 30.0% | 30.0% | 30.0% |
| SG&A expense | 21.0% | 21.0% | 20.0% | 20.0% | 19.0% | 19.0% | 19.0% |
| Operating Margin | 7.0% | 7.0% | 9.0% | 9.0% | 11.0% | 11.0% | 11.0% |
| Taxes as a % of Operating Income | 38.5% | 38.5% | 38.5% | 38.5% | 38.5% | 38.5% | 38.5% |
| **Annual Income Statement** | | | | | | | |
| Sales | 175,000 | 210,000 | 253,964 | 310,871 | 375,905 | 467,314 | 584,998 |
| Costs and Expenses | 126,000 | 151,200 | 180,315 | 220,719 | 263,133 | 327,120 | 409,498 |
| Gross Margin | 49,000 | 58,800 | 73,650 | 90,153 | 112,771 | 140,194 | 175,499 |
| Selling, General, and Administrative | 36,750 | 44,100 | 50,793 | 62,174 | 71,422 | 88,790 | 111,150 |
| Operating Income | 12,250 | 14,700 | 22,857 | 27,978 | 41,350 | 51,405 | 64,350 |
| Taxes | 4,716 | 5,660 | 8,800 | 10,772 | 15,920 | 19,791 | 24,775 |
| Earnings | 7,534 | 9,041 | 14,057 | 17,207 | 25,430 | 31,614 | 39,575 |
| Profit Margin | 4.3% | 4.3% | 5.5% | 5.5% | 6.8% | 6.8% | 6.8% |
| E.P.S. | 0.63 | 0.75 | 1.17 | 1.43 | 2.12 | 2.63 | 3.30 |
| **Statement of Stockholders' Equity** | | | | | | | |
| Beginning Equity | 62,348 | 69,882 | 78,922 | 92,979 | 110,186 | 135,616 | 167,230 |
| + Earnings | 7,534 | 9,041 | 14,057 | 17,207 | 25,430 | 31,614 | 39,575 |
| - Dividends | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| = Ending Equity | 69,882 | 78,922 | 92,979 | 110,186 | 135,616 | 167,230 | 206,805 |
| **Year-End Balance Sheet** | | | | | | | |
| Total Assets | 81,395 | 98,436 | 120,493 | 145,700 | 181,129 | 226,743 | 280,318 |
| Liabilities | 11,514 | 19,514 | 27,514 | 35,514 | 45,514 | 59,514 | 73,514 |
| Stockholders' Equity | 69,882 | 78,922 | 92,979 | 110,186 | 135,616 | 167,230 | 206,805 |
| Total Liabilities and Equity | 81,395 | 98,436 | 120,493 | 145,700 | 181,129 | 226,743 | 280,318 |
| **Financial Ratios** | | | | | | | |
| Profitability | 4.31% | 4.31% | 5.54% | 5.54% | 6.77% | 6.77% | 6.77% |
| x Turnover | 2.39 | 2.58 | 2.58 | 2.58 | 2.58 | 2.58 | 2.58 |
| x Leverage | 1.17 | 1.16 | 1.25 | 1.30 | 1.32 | 1.34 | 1.36 |
| = Return on Equity | 12.1% | 12.9% | 17.8% | 18.5% | 23.1% | 23.3% | 23.7% |

# Exhibit 4: Chronimed Valuation

| Valuation Assumptions | |
|---|---|
| Cost of Equity | 14.9% |
| ROE beyond 2004 | 23.7% |
| Dividend Payout Ratio | 0.0% |
| Growth beyong 2004 | 0.0% |

| | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|---|
| **Inputs From Financials** | | | | | | | |
| Beginning Stockholders' Equity | 62,348 | 69,882 | 78,922 | 92,979 | 110,186 | 135,616 | 167,230 |
| Earnings | 7,534 | 9,041 | 14,057 | 17,207 | 25,430 | 31,614 | 39,575 |
| Dividends | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| **Abnormal Earnings Based Valuation** | | | | | | | |
| Abnormal Earnings | (1,755) | (1,370) | 2,299 | 3,355 | 9,014 | 11,410 | 14,661 |
| Discount Factor | 1.15 | 1.32 | 1.52 | 1.74 | 2.00 | 2.30 | 2.64 |
| Discounted Abnormal Earnings | (1,527) | (1,038) | 1,516 | 1,925 | 4,502 | 4,959 | |
| Discounted Terminal Value | | | | | | | 42,773 |

| | | |
|---|---|---|
| **Market Value** | **115,457** | ( = Beginning BV + Discounted Abnormal Earnings + Discounted Terminal Value) |
| Number of Shares | 12,000 | |
| Price per Share | $9.62 | |
| Half-year payment adjustment | $10.34 | |
| **Adjusted to the End of the 3rd Quarter** | **$11.49** | |

| **Sensitivities** | **Estimated Price** | % of Market | |
|---|---|---|---|
| 1999 projections as a perpetuity | 4.29 | 70% | |
| 1999 projections as a perpetuity plus recap | 7.35 | 120% | (leverage ratio changes to 2.0 in 2001) |
| Base Case but with constant leverage rati | 9.18 | 150% | |
| Base Case | 11.49 | 188% | |
| Base Case plus leveraged recap in 2000 | 15.60 | 255% | (leverage ratio changes to 2.0 in 2001) |

Faculty Comments on and Independent Study Project by

**Rob Eisenbach**

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Chronimed, Inc.

This research report uses the methodology described in Palepu, Bernard and Healy, "Introduction to Business Analysis and Valuation," to estimate the value of Chronimed, a small publicly-traded health-care company. The study demonstrates the application of the model in a clear and concise way.

Russell J. Lundholm
Signature of Faculty Supervisor

Professor of Accounting
Title

4/16/99
Date