Catamaran: A contrarian take on one of Bay Street's favourite stocks

David Milstead, Globe and Mail
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C**atamaran Corp.** has one of the sexiest stories on the TSX: It was Fortune magazine's No. 1 fastest-growing public company in 2011 and nearly cracked the top 10 last year. Unsurprisingly, it has one of the highest valuations on the exchange and earns near universal applause from analysts.

However, it also has, according to ***Veritas Research Corp***., aggressive accounting practices that give the shares unappealingly high risk. Investors who want to sail onward with the company should be wary.

Catamaran was, until recently, known as SXC Health Solutions; the company started 20 years ago in Ontario but now calls the Chicago suburbs its home. It's a "pharmacy benefit manager," a company that helps health plans, large companies, and governments administer prescription-drug programs. Among publicly traded PBMs, it's smaller but faster growing than giants CVS Caremark Corp. (of which I own 50 shares in a retirement account) and Express Scripts Holding Co.

There are different kinds of models for PBM services. To simplify, in many "traditional" relationships, the PBM negotiates a discount on the prices of drugs, marks up the cost to its client, and can also take an additional per-prescription fee. In other "transparent" relationships, the PBM passes along the discount to the customer and takes only the fee. While CVS Caremark and Express Scripts use the traditional model, Catamaran has offered both kinds of models to its customers.

This can make a difference in accounting, ***Veritas*** notes with this example: Let's say the PBM has to pay $100 for a prescription. In the traditional method where the PBM marks it up, it charges the health plan $105 and takes a $2 fee. The cost of processing the prescription is $1. In this method where drug prices are "grossed" to the PBM, revenue is $107, costs are $101, gross profit is $6, and gross profit margin is 5.6 per cent.

Alternately, in the "net" method of accounting, the PBM never shows the cost of the prescription in its income statement; it books just the $2 fee as revenue and shows gross profit of $1, or a margin of 50 per cent.

The difference in revenue, again: $107 versus $2. Significant.

Under U.S. generally accepted accounting principles, which are what Catamaran uses, companies need to make a decision about whether they are a "principal" to the transaction, with a number of risks related to pricing, credit and inventory, or whether they're simply an "agent." Again to simplify, principals book the drug prices as revenue; agents book just the fees.

As it happens, a key part of Catamaran's business model is to take customers for which it performs simple back-office administration, known as health-care information technology, and "convert" them to full PBM relationships. In doing so, Catamaran begins to use gross accounting rather than net accounting.

As ***Veritas's Michael Yerashotis*** and Graham Goulet note, in fiscal year 2007, Catamaran accounted for 100 per cent of its revenue on the net basis. By the second quarter of fiscal 2012, approximately 98 per cent of its revenue was recognized on the gross basis. "What has resulted is an astronomical increase in revenues that dwarfs the increase in actual prescriptions processed." (Specifically, revenue growth of 6,900 per cent, versus prescription growth of 34 per cent.)

The problem, the ***Veritas*** analysts note, is that about two-thirds of Catamaran's business is conducted on a "transparent" model with no drug markups. And while the company said in 2008 that transparent contracts would use the net method, "based on our understanding of Catamaran's current accounting policies, it seems that … is no longer true."

The ***Veritas*** analysts looked at a number of the company's "conversions" of customers to full PBM services and questions "whether the substance of the relationships have materially changed … we believe the economic facts surrounding each of the customer arrangements do not support a change in accounting treatment from the net to gross method."

Catamaran spokesman Tony Perkins declined to comment for this story, saying the company does not comment on analyst reports and that ***Veritas's*** questions "have been addressed."

Veritas says it corresponded with management, but says it does not have all the information that might be relevant in assessing Catamaran's compliance with accounting standards.

So why does any of this matter? Catamaran, which hit a 52-week high Monday, trades at a forward price-to-earnings ratio of more than 30, per Standard & Poor's Capital IQ, versus about 13 for each of its larger competitors. The ***Veritas*** analysts say that as Catamaran continues to convert customers to lower-margin PBM relationships in the name of revenue growth, its expected profit growth — analysts expect a doubling by 2014 — looks unrealistic.

By plugging in lower-margin revenue and assuming investors will chop Catamaran's multiple as a result, the ***Veritas*** analysts sees potential declines in the share price of anywhere from 35 per cent to 68 per cent. "We advise investors to put this one in the too-risky-to-be expensive bucket."

They, it should be said, are lonely: Of 26 analysts listed by Bloomberg, just one other has a "sell" rating; 19 have "buys." The Street is very nearly all-in on the Catamaran growth story. If there are holes in it, however, this stock could quickly take on water.