

McKesson Corporation (MCK)

\$139.47 (As of 03/17/20)

Price Target (6-12 Months): **\$146.00**

Long Term: 6-12 Months

Zacks Recommendation:

Neutral

(Since: 11/22/19)

Prior Recommendation: Outperform

Short Term: 1-3 Months

Zacks Rank: (1-5)

2-Buy

Zacks Style Scores:

VGM:C

Value: A

Growth: D

Momentum: F

Summary

McKesson exited the fiscal third quarter on a mixed note, wherein the bottom line beat the consensus mark while the top line missed the same. Strong fiscal third-quarter show by the segments — U.S. Pharmaceutical and Specialty Solutions, Medical-Surgical Solutions and Other — instills investor optimism in the stock. Further, management remains optimistic about the McKesson and Walgreens Boots Alliance agreement to form a JV that is anticipated to combine their respective pharmaceutical wholesale businesses in Germany. The company also launched an Opioid Foundation recently to address the current U.S. opioid crisis. McKesson has outperformed the industry in a year's time. However, contraction in gross margin adds to woes. Price fluctuation of generic pharmaceuticals and stiff competition in the MedTech space remain concerns.

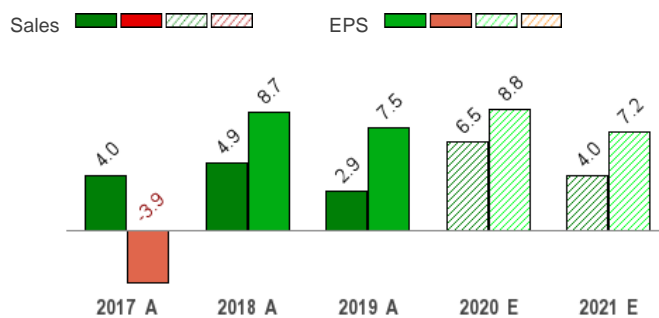
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$172.18 - \$111.71
20 Day Average Volume (sh)	10,985,623
Market Cap	\$24.7 B
YTD Price Change	0.8%
Beta	1.03
Dividend / Div Yld	\$1.64 / 1.2%
Industry	Medical - Dental Supplies
Zacks Industry Rank	Top 18% (45 out of 253)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	7.6%
Last Sales Surprise	-0.4%
EPS F1 Est- 4 week change	0.0%
Expected Report Date	05/13/2020
Earnings ESP	0.0%

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	58,493 E	60,074 E	61,313 E	57,294 E	237,276 E
2020	55,728 A	57,616 A	59,172 A	55,600 E	228,197 E
2019	52,607 A	53,075 A	56,208 A	52,429 A	214,319 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$3.62 E	\$3.89 E	\$3.98 E	\$4.40 E	\$15.84 E
2020	\$3.31 A	\$3.60 A	\$3.81 A	\$4.09 E	\$14.77 E
2019	\$2.90 A	\$3.60 A	\$3.40 A	\$3.69 A	\$13.57 A

*Quarterly figures may not add up to annual.

P/E TTM	9.7
P/E F1	9.4
PEG F1	1.3
P/S TTM	0.1

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 03/17/2020. The reports text is as of 03/18/2020.

Overview

San Francisco, CA-based McKesson Corporation is a health care services and information technology company. McKesson operates through two segments:

The Distribution Solutions segment distributes branded and generic pharmaceutical drugs along with other healthcare-related products on a global basis worldwide. The segment also provides practice management, technology, clinical support and business solutions to community-based oncology and other specialty practices. In addition, the segment provides specialty pharmaceutical solutions for pharmaceutical manufacturers including offering multiple distribution channels and study access to oncology physicians. The segment also provides medical-surgical supply distribution, equipment, logistics and other services to healthcare providers within the U.S.

The Technology Solutions segment provides enterprise-wide clinical, patient care, financial, supply chain, and strategic management software solutions.

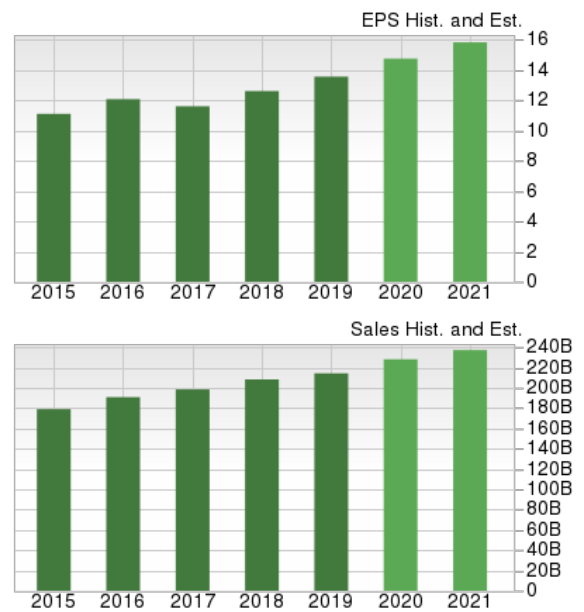
However, in the first quarter of fiscal 2019, McKesson reported revenues through three segments: U.S. Pharmaceutical and Specialty Solutions, European Pharmaceutical Solutions, Medical-Surgical Solutions.

Acquisitions

In Jan 2018, McKesson announced that it has completed the acquisition of RxCrossroads from CVS Health Corp. RxCrossroads is a provider of tailored services to pharmaceutical and biotechnology manufacturers. The transaction is valued at \$735 million and has been entirely funded by cash on hand. RxCrossroads will become part of McKesson's Specialty Health business. In Jun 2018, McKesson completed the acquisition of MSD for the net purchase consideration of \$784 million, which was funded from cash on hand.

FY19 at a Glance

Revenues in fiscal 2019 grossed \$214.32 billion, compared with \$208.36 billion a year ago. U.S. Pharmaceutical and Specialty Solutions (78% of net revenues), European Pharmaceutical Solutions (13%), Medical-Surgical Solutions (4%) and Other (5%).



Reasons To Buy:

- ▲ **Share Price Performance:** In the past year, shares of McKesson have gained 13.8% against the industry's decline of 26.7%. Meanwhile, the S&P 500 Index's declined 16.6%.

Multi-year growth initiatives, acquisitions and strategic collaborations and strong position in the pharmaceutical and medical supplies distribution market bolster the company's prospects.

- ▲ **Multi-Year Growth Initiatives:** In recent times, McKesson announced a multi-year strategic growth initiative, focused on creating innovative new solutions that improve patient care delivery and drive incremental profit growth. The plan is to implement differential pricing for brand, generic, specialty, biosimilar and OTC (Over-the-counter) drug classes in line with services offered to both customers and manufacturers. As discussed in the fiscal third quarter earnings call, McKesson is on track when it comes to its multi-year strategic growth initiative update that is currently expected to generate approximately \$400 million to \$500 million (up from the previously guided range of \$300-\$400 million) in annual pre-tax gross savings. This will be substantially realized by the end of fiscal 2021.

Management aims to increase efficiency, accelerate execution and improve long-term performance through its initiatives that consist of multiple growth pillars.

- ▲ **Strong Player in Distribution Market:** McKesson is a major player in the pharmaceutical and medical supplies distribution market.

The Distribution Solutions segment caters to a wide range of customers and businesses and stands to benefit from increased generic utilization, inflation in generics driven by several patent expirations in the next few years, and an aging population.

During the fiscal second quarter, the company opened a new distribution center in the Seattle area – an eco-friendly facility boasting of the latest in supply chain technology and state-of-the-art automation.

It is encouraging to note that, in the fiscal fourth quarter 2019, Rite Aid renewed its 10-year distribution and sourcing relationship with McKesson, while pharmaceutical distribution relationship with CVS Health was renewed through June 2023.

Additionally, in the fiscal third quarter 2019, McKesson launched its Opioid Foundation that will focus on helping advance solutions to the U.S. opioid crisis. Per management, the company has contributed \$100 million toward building the foundation for opioid response efforts — a foundation dedicated entirely for driving solutions to the epidemic.

- ▲ **Acquisitions & Strategic Collaborations:** McKesson has been actively pursuing deals, divestitures and acquisitions to drive growth. Recently, MedTech bigwig, Cerner Corporation collaborated with McKesson's CoverMyMeds, a wholly-owned subsidiary of its Prescription Technology Solutions sub unit.

In recent past, McKesson completed the acquisition of RxCrossroads from CVS Health Corp. RxCrossroads is a provider of tailored services to pharmaceutical and biotechnology manufacturers. The transaction is valued at \$735 million and has been entirely funded by cash on hand. McKesson had also acquired electronic prior authorization solutions provider to pharmacies, providers, payers and pharmaceutical manufacturers—CoverMyMeds.

During the fiscal third quarter, CoverMyMeds and RxCrossroads announced the launch of AMP (Access for More Patients), which is a first-in-class technology driven patient support solution that transforms how patients access afford and adhere to their medications.

On Dec 12, 2019, McKesson and Walgreens Boots Alliance announced an agreement to form a joint venture (JV) that is anticipated to combine their respective pharmaceutical wholesale businesses in Germany.

- ▲ **Divestitures:** In an initiative to focus on core strength, McKesson's divested Enterprise Information segment in recent past. Notably, the Enterprise Information Solutions portfolio included a robust set of clinical and financial solutions supporting the full scope of care delivery processes — including Paragon (EHR solution); STAR and HealthQuest (Revenue Cycle solutions); Lab Analytics and Blood Bank; and OneContent (Content Management solutions).

Notably, on February 4, 2020, McKesson's wholly-owned subsidiary, PF2 SpinCo, Inc., filed a registration statement with the Securities and Exchange Commission (SEC) with regards to a potential exit of the company from its investment in the Change Healthcare JV.

- ▲ **Separating Technology Business:** In recent past, McKesson divested its Technology Solutions business and merged the same with Change Healthcare Holdings to form a new healthcare information technology entity.

The Technology Solutions business had been facing challenges for quite some time as revenues declined. Hence, in a bid to focus on its core distribution business, McKesson offered the majority of its Technology Solutions businesses to Change Healthcare but has retained RelayHealth Pharmacy and Enterprise Information Solutions (EIS). McKesson is currently holding 70% of the new company. Meanwhile, McKesson's Prescription Technology Solutions displayed strong performance in the fiscal first quarter. Per management, the company continues to make investments in this business, which in turn will position it well for future growth.

- ▲ **McKesson Canada Improves:** McKesson Canada plays a crucial role in providing solutions to manufacturers, pharmacies and hospitals, which cater to the needs of patients in Canada every day. In the fiscal third quarter, the company witnessed growth in Canadian operations.

It is encouraging to note that the company made substantial progress in mitigating the impact of government-imposed generic pricing cuts throughout fiscal 2019. Additionally, McKesson Canada also has broad specialty assets and capabilities and is well-positioned to participate in the growth of specialty in the Canadian market.

McKesson has been pursuing deals and acquisitions to drive growth. The company is a major player in the pharmaceutical and medical supplies distribution market.

Reasons To Sell:

▼ **Other Global Headwinds:** Per management, reimbursement and minimum wage headwinds impact the entire Canadian supply chain and retail pharmacy operations extensively. Similar headwinds prevail in the U.K., which have affected the company's fiscal 2019 performance. Moreover, the company expects the hindrances to persist in the quarters ahead. The company continues to keep track of the retail pharmacy funding dynamics. As previously discussed in the fiscal year 2020, the retail pharmacy industry experienced underfunding by the NHS in its first quarter. While there was a modest improvement in the fiscal second quarter, further upward revisions have not yet been implemented.

Sluggish growth in the pharmaceutical distribution business is concerning. Global regulatory headwinds persist.

Management stated in the fiscal second-quarter earnings call that European Pharmaceutical Solutions is anticipated to deliver low single-digit percent growth in operating profit in fiscal 2020. The company estimates flat to low single-digit percent decline in revenues.

▼ **Escalating Pricing Pressure:** McKesson reaffirmed fiscal 2020 guidance of branded inflation in the mid-single digits. Additionally, during fiscal 2019, McKesson witnessed increased price competition in the independent retail pharmacy channel. The company continues to face intense competition for selling generic pharmaceuticals in the United States.

▼ **Weak Trends:** McKesson distributes generic pharmaceuticals, which are subject to price fluctuation. The Distribution Solutions segment had experienced weaker generic pharmaceutical pricing trends, which continue to persist. Continued volatility, unfavorable pricing trends, reimbursement of generic drugs, significant fluctuations in the nature, frequency and magnitude of generic pharmaceutical launches could have a material adverse impact on McKesson.

▼ **Stiff Competition:** Distribution Solutions faces stiff competition both in terms of price and service from various full-line, short-line and specialty wholesalers, service merchandisers, self-warehousing chains, manufacturers engaged in direct distribution, third-party logistics companies and large-payer organizations. Moreover, the company depends on fewer suppliers for its products. As a result, it is not in a position to negotiate pricing.

Also, the prices for company's products and services may erode due to greater bargaining power of other healthcare enterprises. In addition, the company's Technology Solutions segment experiences substantial competition from many firms, including other software services firms, consulting firms, shared service vendors, certain hospitals and hospital groups, payers, care management organizations, hardware vendors and internet-based companies with technology applicable to the healthcare industry.

Last Earnings Report

McKesson Q3 Earnings Beat Estimates, Revenues Miss

McKesson Corporation's reported third-quarter fiscal 2020 earnings of \$3.81 per share, which beat the Zacks Consensus Estimate of \$3.54 per share by 7.6%. Further, the bottom line improved 12.1% on a year-over-year basis.

Revenues came in at \$59.17 billion, which missed the Zacks Consensus Estimate by 0.4%. However, the figure improved 5.3% year over year.

Quarter Ending **12/2019**

Report Date	Feb 04, 2020
Sales Surprise	-0.42%
EPS Surprise	7.63%
Quarterly EPS	3.81
Annual EPS (TTM)	14.41

Q3 Segmental Analysis

Revenues at the **U.S. Pharmaceutical and Specialty Solutions** segment totaled \$46.92 billion, up 6% year over year. Per management, the upside was primarily driven by branded pharmaceutical price increases and higher volumes from retail national account customers. However, branded to generic conversions partially offset the upside.

At the **European Pharmaceutical Solutions** segment, revenues amounted to \$6.93 billion, up 0.3% year over year. Further, the metric rose 3% at constant currency (cc) on the back of growth in the pharmaceutical distribution business.

Revenues at the **Medical-Surgical Solutions** segment totaled \$2.14 billion, up 6.4% year over year. Growth in the Primary Care business, driven by higher volume of pharmaceutical products and an early start to influenza season, drove the upside.

Revenues at the **Other** segment were \$3.18 billion in the fiscal third quarter, improving 5.7% year over year and 5% at cc. Growth in the Canadian business primarily contributed to the upside.

Margins

Gross profit in the reported quarter was \$3.03 billion, up 2.1% on a year-over-year basis. Meanwhile, gross margin was 5.1% of net revenues, down 20 bps.

Operating income in the quarter was \$360 million, which plunged 47.3% from the year-ago quarter figure of \$683 million.

The U.S. Pharmaceutical and Specialty Solutions segment reported adjusted operating profit of \$658 million, up 11% from the prior-year quarter. Adjusted operating margin was 1.4% at the segment.

Adjusted operating profit at the European Pharmaceutical Solutions segment amounted to \$80 million, up 16% from the year-ago quarter. Meanwhile, the adjusted operating margin at the segment was 1.2%.

The Medical-Surgical segment had adjusted operating profit of \$184 million, which improved 8% from the year-ago quarter. Adjusted operating margin was 8.6% at the segment.

Adjusted operating profit was \$214 million at the Other segment, down 4% from the prior-year quarter.

Financial Update

In the quarter under review, cash and cash equivalents came in at \$2.07 billion, up 52.3% sequentially.

Cash flow from operating activities for the nine months ended as of Dec 31, 2019, came in at (\$280) million, against the year-ago quarter figure of 141 million.

Fiscal 2020 Guidance Reiterated

McKesson has reiterated fiscal 2020 guidance (announced Jan 13, 2020). For fiscal 2020, the company projects adjusted earnings per share in the range of \$14.60-\$14.80.

Valuation

McKesson's shares are up 0.8% and 13.8% in the year-to-date period and the trailing 12-month periods, respectively. Stocks in the Zacks sub-industry and Zacks Medical Market are down 14.2% and 16.9% in the year-to-date period, respectively. Over the past year, the stocks in the Zacks sub-industry are down 18.3% while that in the sector are 20.1%.

The S&P 500 index is down 25.8% in the year-to-date period and 16.6% in the past year.

The stock is currently trading at 8.8X Forward 12-months earnings, which compares to 14.9X for the Zacks sub-industry, 17.1X for the Zacks sector and 14.8X for the S&P 500 index.

Over the past five years, the stock has traded as high as 20.5X and as low as 7.7X, with a 5-year median of 11.5X.

Our Neutral recommendation indicates that the stock will perform in line with the market. Our \$146 price target reflects 9.2X forward 12-months earnings.

The table below shows summary valuation data for MCK.

Valuation Multiples - MCK					
		Stock	Sub-Industry	Sector	S&P 500
P/E F12M	Current	8.83	14.87	17.13	14.79
	5-Year High	20.47	19.57	21.08	19.34
	5-Year Low	7.68	13.7	15.81	14.79
	5-Year Median	11.51	16.56	18.73	17.42
P/S F12M	Current	0.1	0.3	2.33	2.71
	5-Year High	0.3	0.36	3.84	3.43
	5-Year Low	0.09	0.23	2.33	2.54
	5-Year Median	0.15	0.28	2.96	3
P/B TTM	Current	3.87	3.74	3.81	3.4
	5-Year High	6.99	4.93	5.05	4.55
	5-Year Low	2.22	2.53	3.45	2.85
	5-Year Median	3.31	3.45	4.32	3.63

As of 03/17/2020

Industry Analysis Zacks Industry Rank: Top 18% (45 out of 253)



Top Peers

Cardinal Health, Inc. (CAH)	Outperform
AmerisourceBergen Corporation (ABC)	Neutral
CVS Health Corporation (CVS)	Neutral
Henry Schein, Inc. (HSIC)	Neutral
Owens & Minor, Inc. (OMI)	Neutral
Thermo Fisher Scientific Inc. (TMO)	Neutral
Walgreens Boots Alliance, Inc. (WBA)	Neutral
Nu Skin Enterprises, Inc. (NUS)	Underperform

Industry Comparison Industry: Medical - Dental Supplies				Industry Peers		
	MCK Neutral	X Industry	S&P 500	ABC Neutral	CAH Outperform	TMO Neutral
VGM Score	C	-	-	A	A	C
Market Cap	24.68 B	1.36 B	17.72 B	18.43 B	13.94 B	118.18 B
# of Analysts	8	5	13	8	8	9
Dividend Yield	1.18%	0.00%	2.51%	1.88%	4.03%	0.30%
Value Score	A	-	-	B	A	C
Cash/Price	0.09	0.07	0.06	0.17	0.12	0.02
EV/EBITDA	7.98	10.47	10.97	11.61	6.25	18.92
PEG Ratio	1.34	1.51	1.54	1.57	1.46	1.56
Price/Book (P/B)	3.86	3.32	2.39	6.00	13.94	4.00
Price/Cash Flow (P/CF)	4.69	11.31	9.36	9.25	5.50	16.38
P/E (F1)	9.44	16.55	13.98	11.63	8.97	21.80
Price/Sales (P/S)	0.11	1.29	1.87	0.10	0.09	4.63
Earnings Yield	10.59%	4.81%	7.13%	8.59%	11.14%	4.59%
Debt/Equity	1.33	0.32	0.70	1.18	6.73	0.58
Cash Flow (\$/share)	29.73	1.35	7.01	9.67	8.69	18.08
Growth Score	D	-	-	A	B	B
Hist. EPS Growth (3-5 yrs)	4.15%	8.88%	10.85%	8.88%	2.79%	13.63%
Proj. EPS Growth (F1/F0)	8.81%	10.13%	5.38%	8.52%	0.85%	10.09%
Curr. Cash Flow Growth	-1.89%	8.60%	6.15%	-0.05%	-0.80%	6.99%
Hist. Cash Flow Growth (3-5 yrs)	16.28%	12.65%	8.55%	12.37%	7.74%	10.08%
Current Ratio	0.98	1.65	1.24	0.95	1.03	1.92
Debt/Capital	60.82%	27.49%	42.57%	54.23%	87.06%	36.53%
Net Margin	-0.41%	3.00%	11.57%	0.36%	-2.81%	14.47%
Return on Equity	36.40%	15.19%	16.74%	49.95%	45.21%	17.24%
Sales/Assets	3.73	1.02	0.54	4.65	3.70	0.45
Proj. Sales Growth (F1/F0)	6.48%	3.83%	3.33%	6.05%	5.08%	5.38%
Momentum Score	F	-	-	D	F	C
Daily Price Chg	15.00%	4.66%	5.62%	11.18%	8.01%	6.07%
1 Week Price Chg	-6.30%	-10.40%	-11.01%	4.88%	-7.12%	-3.55%
4 Week Price Chg	-16.80%	-23.56%	-28.54%	-5.10%	-19.07%	-12.17%
12 Week Price Chg	0.48%	-8.97%	-25.74%	4.78%	-6.88%	-9.25%
52 Week Price Chg	13.83%	-23.07%	-18.88%	10.40%	-5.52%	11.41%
20 Day Average Volume	10,985,623	470,446	3,651,283	2,603,123	3,620,897	2,852,690
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
(F1) EPS Est 4 week change	0.00%	-0.10%	-0.58%	0.00%	0.00%	-0.10%
(F1) EPS Est 12 week change	2.56%	-0.58%	-1.18%	2.06%	6.20%	0.04%
(Q1) EPS Est Mthly Chg	0.00%	-0.16%	-0.77%	0.00%	0.00%	-0.08%

Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	A
Growth Score	D
Momentum Score	F
VGM Score	C

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

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