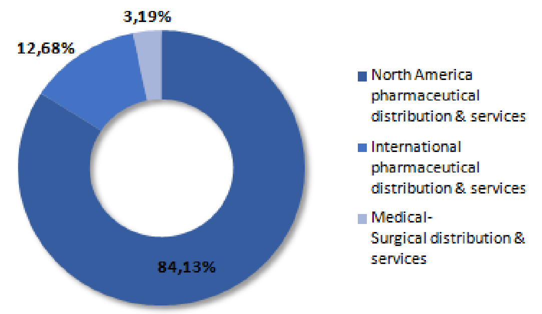
McKesson Corporation (MCK)

Final Project

Axel SATEGNA



Summary : SWOT Analysis

Strengths:

-Diversification by location and products/services

-Leader in the US and Canadian market

-Low Debt compare to equity for the industry

Opportunities:

-New healthcare technologies

-US Demography (Close to 70% of revenues)

Weaknesses:

-High revenues coming from few customers

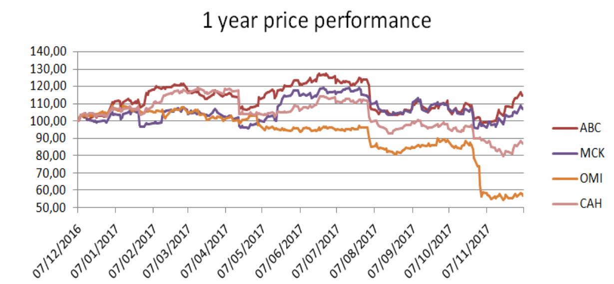
-Depend of the US Market

Threats:

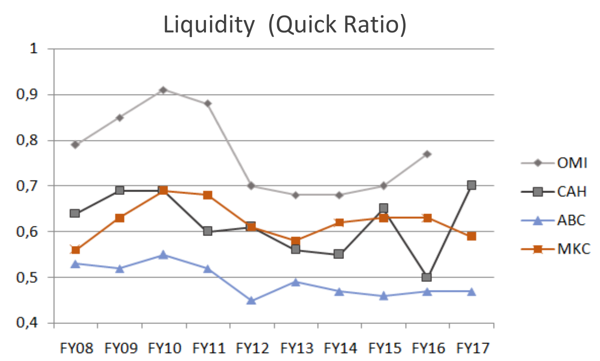
-Brexit conflict

-High competition environment

-Slow economic growth in EU



Comparison FY16	MCK	ABC	CAH	OMI
ROA	4.09%	4.65%	4.44%	3.92%
ROE	26.68%	103.36%	22.28%	11.03%
P/E *	7.7	54.5	17.6	14.8
Profit Margin	1.18%	0.97%	1.17%	1.12%
D/E	0.73	1.82	0.76	0.59
Current Ratio	1.10	0.90	1.11	1.90



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BUSINESS DESCRIPTION

› **MCKESSON CORPORATION** is an American pharmaceutical company based in San Francisco, CA, United Stated. They are listed as the 11th biggest company in the World in term of revenues according to Forbes in 2016. In 2016 revenues reached $191B and in 2017 there is recognition of $198B, a grow of +4%

› The core business is mainly focussing on the Distribution Solutions ($195.9B in 2017) and Technology Solutions ($2.6B in 2017) Therefore, they deliver pharmaceuticals and medicals products to medical retails and institutions such as hospitals, pharmacies technology, equipment and services. They operate in the US (50 states), Canada and Europe (13 countries). Within the European market, more than 70% of EU revenues are generated from the UK and the Scandinavian countries.

› More than 84% of revenues have been generated during the FY 17 in the North America market.

› As shown in their budget, a huge amount of money is currently being invested in the latest technologies. A specific division named Mckesson RX technology Solutions fragmented in different branch such as: McKesson Pharmacy Technology and Services (MPTS), RelayHealth Pharmacy (RHP) and others. These sections contain software and robots allowing to improve the business as a whole, such as EntrepriseRx, Pharmaserv or ROBOT –RX in order to optimizing the packaging time and increasing safety.

› **COMPETITION**: AmerisourceBergen Corporation (ABC) created in 1871 is an American company generating $153B revenues in FY17, an increase of 4% since the FY16. This company is the main competitor of MCK, specialized in Health Systems, Pharmacies, and physician practices and manufactures.Cardinal Health Inc (CAH), specialized in healthcare solution, Logistics & Supplies is an US company created in 1971 recognizes $130B in FY17 (+7% in 1 year). Owen & Minor Inc (OMI), specialized on Healthcare Logistics and medical Supplies (US company) created in 1882 and has generated in FY16 $9,5B being -0.50% since FY15.

› MCK is not a leveraged company comparing the solvency analysis. The liquidity ratio shows to investors as well as lenders that the firm is well positioned to pay back its liabilities. Best management of net earnings over revenues measure by profit margin, with an average of 1.11% in this sample industry.

08 Dec 2017

HOLD

INVESTEMENT SUMMARY

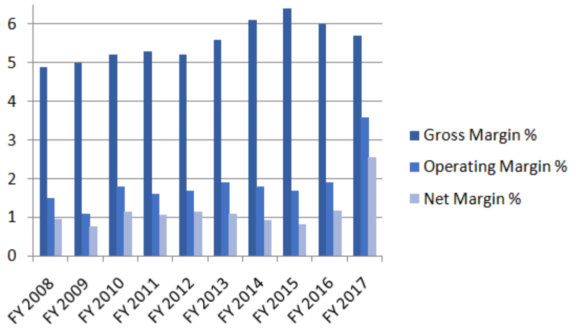
McKesson Corporation (MCK) - US58155Q1031

Snap Shot

› Net income increased + 125% from FY16 to FY17

› The Gross Margin decreased by -5%

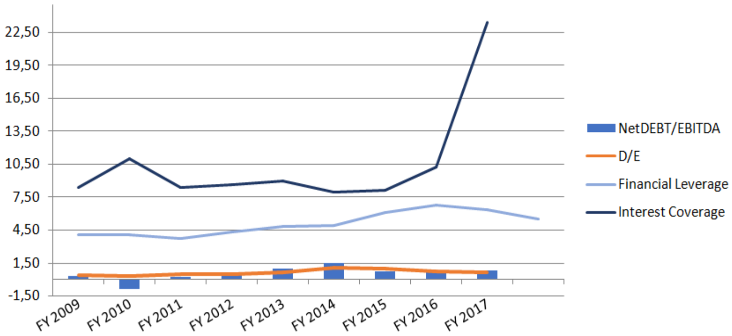
› Operating incomes grow up by + 101%



› Reduction of the financial lever -13.25%

› Debt is reducing by - 2.78%

› Interest coverage reaches 23.37. Able to pay the interest expenses



Market Information

Closing Price	$152.59
Date of Price	08/12/2017
Beta	1.28
Exchange	NYSE
Target Price (up to 5ys)	$132.60
Currency	USD
52 W Ranges	133.82 – 153.00
Market Cap – Large Cap	$ 32.07 B

Market Performance – 1 year

Returns	6.80%
Volatility	24.93%

Market Performance – 5 years

Returns	10.28%
Volatility	18.33%

Corporate Performance (FY 2017)

ROA	8.63
ROE	50.65
Current Ratio	1.04
D/E	0.66
Payout Ratio	12.4
Net Income	5.07B

INVESTMENT RECOMMENDATION: We have issued a Hold recommendation for MCK with a target price of. The target price is based on a DDM analysis. However we are suggesting a Sell proposition during February before the FY18.
Our DCF valuation indicates a predicted price of $111.09 up to 5 years. And the P/B could be the sign of an undervalued stock face to ABC, Cardinal Health, Henry Schein competitors.

CONCLUSION: McKesson Corporation will increase in the short run but will decrease in a long run. It’s considerate as a value company. The company remain very liquid thanks to the short CCC equal to 3.36. The ROE is at its highest point since 2008 with an increase of 89.8% in one year. However, the beta shows that the stock contains a higher risk than the market

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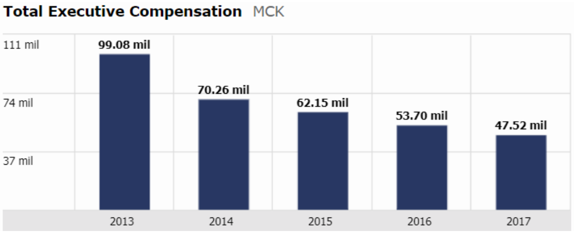


Key employees
CEO - John Hammergren (2001), Chairman of the board (2002)
CFO - James A. Beer (2013)
HRD - Jorge L. Figueredo (2008)
CIO/CTO - Kathy McElligott (2015)
Corporate Strategy - Bansi Nagji (2015) Business Development
CCO/General CNsl - Lori A. Schechter (2014)

Shareholder	Ownership %
Wellington Mana C	10.66
Vanguard Group	6.70
State Street	4.56
BlackRock	2.90
Parnassus	2.13
Par Capital Mg	1.81
Vulcan Value	1.59

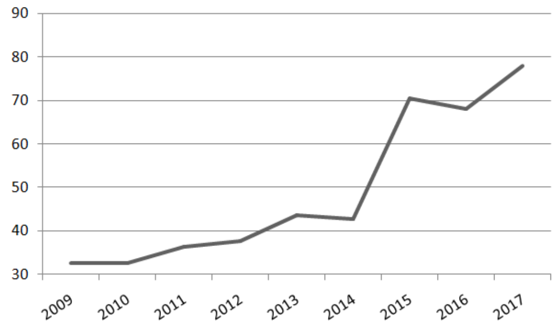
Funds	Ownership %
Vanguard HealthCare	3.84
Vanguard Total S	2.40
Vanguard Dividend	2.09
Vanguard 500	1.67
SPDR	1.23

MANAGEMENT AND GOVERNANCE

LEADERSHIP: MCK is headed by John Hammergren, who has been elected in 2001 CEO and Chairman in 2002. The company has quadrupled revenues to $ 190 billion, and became the 5th number on the Fortune 500. It's the global leader in the Healthcare sector.

SHAREHOLDERS: Shareholder of this company is split between Institutions, Funds and Insiders. Actually, there is 0.1% owned by Insiders. This rate is lower but constant compare to its main competitors such as ABC (0.3%), CAH (0.5%).The total number of owners selling (-2.11%) is lower than the total of owners buying (8.79%) from Q3. Stable ownership over time and expected to follow this trend.

EMPLOYMENT: During the FY17, with more than 78,000 employees in US, Canada and Europe. Higher investments to train its employees represent an increase of + 88.14% since FY16. A loss of 1,600 jobs because of a lost of some key customers

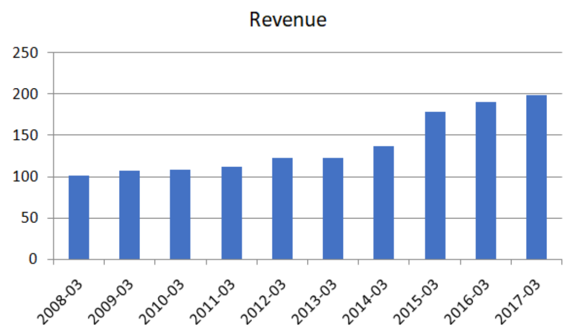


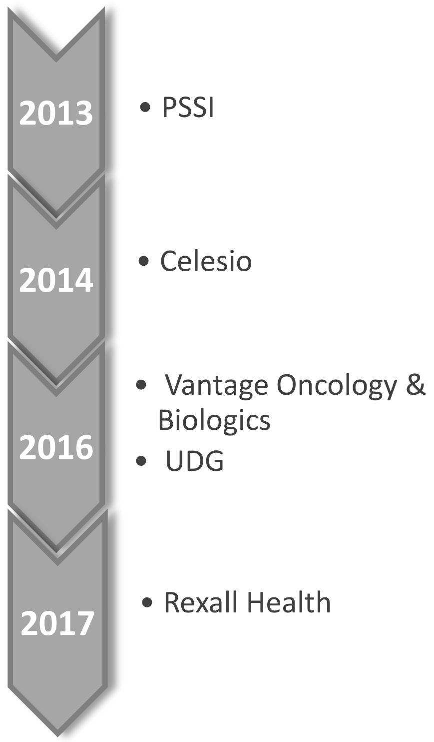
Work place violence training (US only), and environmental training reach + 512% (26k in 2017 against 4K in 2016). The objective is to orient and give instruction on safe work practices. One key strategy is to reduce inequality between genders called "Diversity and Inclusion in the US".

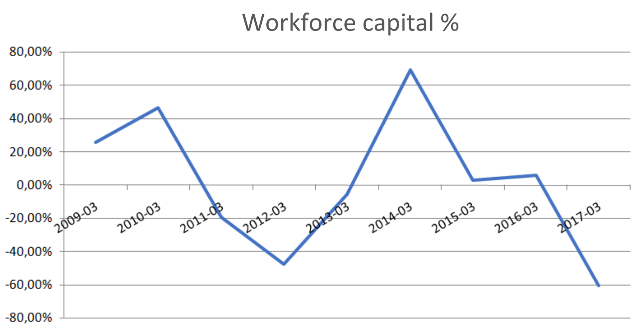
ENVIRONMENT: It's trying to reduce the Emission on 3 pillars, the emission on vehicles, the electricity emission and the travel emission.

› Reduction of the Carbon Footprint. Fleet CO_2 emissions reduced by -5.29% and the Air Travel emission by -4.26%

STRATEGIES & ENVIRONMENT







› **ACQUISITION**: One of its main strategies since a few years is to work of Merging & Acquisition. This is reflected in a higher operating expense level for FY16 with $203m and FY17 $18m within the Income Statement. High investment also reflected in the total property, plant and equipment increase by 0.61% in 2017.

‹ Rexall Health a retail pharmacy chain in the Canada for $2.1Bn

‹ Vantage Oncology LLC and Biologics Inc for $1.2Bn (April 2016)

‹ CMM – CoverMyMeds LLC (April 3, 2017) for $1.3Bn + $0.2Bn because of CMM's financial performance until 2019.

‹ Pharmaceutical Distribution of UDG plc based in Ireland and the U.K for $431m

‹ J Sainsbury Plc

‹ PSSI - PSS World Medical Inc. in February 2013

‹ Celesio – Celesio AG in February 2014

› **RISK**: By acquiring this quantity of business in a short term might impact the business and create uncertainty on different aspects. MCK expose itself to higher risk such as the diversification of the management; geopolitical aspect; foreign exchange; regulatory; customer behaviour and so on.

› **RESTRUCTURING**: Cost alignment plan implementation, consists of a reduction in workforce and business process has seen before. This will allow to reduce operating costs (distribution, administrative & technology), and abandon non-core businesses. A benefit of $250m expected.

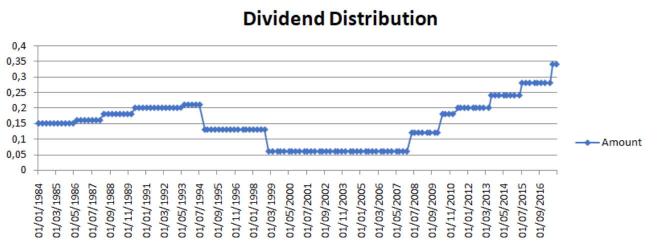
‹ **WORKING CAPITAL:** The expenses reduction, decrease the working capital by -60.3% in FY17. For the management cost this represents -12.10% since the previous year (going from $53.7m to $47.5m in 2017). The consequences of this diminution if this is not well managed might be:

› **SELLING BUSINESS:** If a business doesn't work well and is considerate as too risky, MCK act to sale the business.
Sale of the Brazilian pharmaceutical distribution business (February 2016) has generated an after tax loss of $113m. This business has been acquired through the acquisition of Celesio (2014).

FINANCIAL ANALYSIS

(U.S GAAP)

Financial Analysis	FY15	FY16	FY17
Activity Ratios			
Inventory Turnover	12,15	12,11	12,23
DOH	30,05	30,13	29,83
Receivables Turnover	13,96	13,94	13,75
DSO	26,16	26,18	26,54
Payables Period	50,73	54,66	58,09
Working Capital Turnover	63,26	67,44	70,15
Asset Turnover	83,92	88,31	86,89
Cash Conversion Cycle	5,48	1,66	-1,72
Profitability Ratios			
Gross Profit Margin	6.37	5.98	5.68
Operating Margin profit	1.66	1.86	3.58
Net Profit Margin	0,82	1,18	2,55
ROA	2,79%	4,09%	8,63%
ROE	17,87%	26,68	50,65%
Growth Ratios			
Revenue Growth	30,11%	6,61%	4,01%
EBITDA Growth	37,33%	0,04%	-1,27%
Net income Growth	16,86%	52,98%	124,53%
Asset / Equity	10,84%	-5,89%	-13,30%
Total Asset Turnover	6,60%	1,77%	-2,03%
Liquidity Ratios			
Current Ratio	1.09	1.10	1.04
Quick Ratio	0.63	0.63	0.59
Solvency Ratios			
Debt-to-assets ratio	0,18	0,14	0,14
Debt-to-equity ratio	1.02	0.73	0.66
Net Debt/EBITDA	0,73	0,63	0,84
Interest Coverage	8,10	10,21	23,37
Financial Leverage ratio	6,73	6,34	5,50



› Revenues increased from $190,8Bn in 2016 to $198,5Bn in 2017 as shown before, it represents an increase of +4%. Thanks to an increase of 4.2% in the Distribution solutions since the previous year. This is explained as a maximization of the distribution efficiency (Six Sigma methodology is followed: improve processes – reduce costs – safety) and thanks to the market growth and the UDG acquisition.

› EBITDA goes from $11,4Bn in 2016 to $11,2Bn in 2017. This represents -1.27%, because of +4.34% in COGS.

› EBIT has increased consistently going from $3.45bn to $7.10bn in 2017 (+100.54%). Explained especially by an "Other operating expense" within the Income Statement counted positively in the EBIT. Hence, the technology solutions segment (EIS business) in Change Healthcare (70% equity ownership) bring a gain on Healthcare Technology Net Asset Exchange ("*Results of Operations: Overview*")

› Interest expense decreased in 2017 due to repayment of debt. And has decreased in 206 due to repayment of debt and favourable foreign currency effect (-5.61% FY16 and -12.75% FY17)

› MCK improved itself thanks to the CCC measures; we can see the evolution going from 5.48 in 2015, 1.66 in 2016 and to -1.72 in 2017. The inventory diminished in 2017 by -1%. This gap is meanly due to the increase in the DPO +6.28% in 2017.

› Thus, provision for Income Taxes has doubled: $0,908Bn in FY16 against $1,614Bn (+77.7%)

› From its operations, MCK generated $4,18Bn of FCF compare to $2,9Bn (+39.6%) in 2017. Thanks to the gain on Healthcare Tech, the impact is highly positive.

› MCK was highly leveraged in the FY15 and tend to diminish its debt trough (-9.6%) in 2017. Because of a decrease in total debt (short + long), -2.8% in 2017 and an increase of net earnings seen above has increased the Stockholders' equity amount ($15,78Bn to $18,2Bn – +15.34% in 2017). Consistent Stock repurchase since the 2years: $2,250Bn – FY17, $1,598Bn – FY16.

› Higher dividend per share distributed to shareholders, related to the US GDP shows the healthy position of MCK for investors, $1,08Bn to $1,12Bn of dividend paid, +3,70% in FY17.

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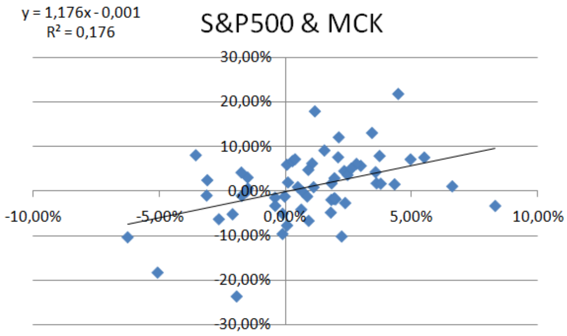
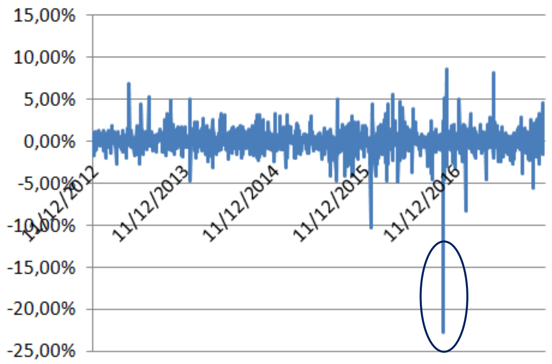
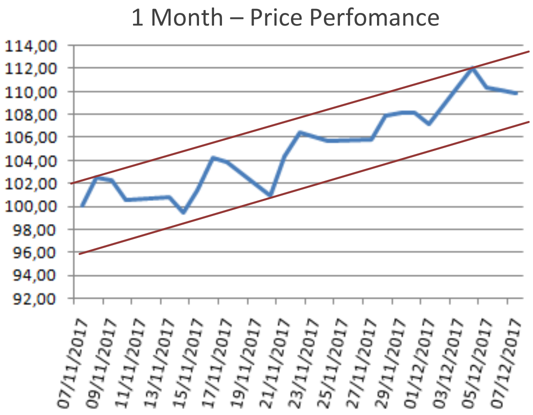




Dividend Distribution

FY	Dividend $	%Growth
2010	0,66	37,50%
2011	0,78	18,18%
2012	0,8	2,56%
2013	0,88	10,00%
2014	0,96	9,09%
2015	1	4,17%
2016	1,12	12,00%
2017	1,24	10,71%
Mean		13,03%
Median		10,36%



Date	DPS	EPS	Payout Ratio
2013	0,88	5,59	12,10%
2014	0,96	5,41	16,50%
2015	1	6,27	13,10%
2016	1,12	9,7	10,90%
2017	1,24	22,73	12,40%

VALUATION 1: DIVIDEND DISCOUNTED MODEL

› MCK equity side is composed by common stock, preferred stock and equity commingled funds. As seen before, the company tends to use share buyback strategy, that increase the EPS consistently the ROA by +46.6% FY15-FY17 and ROE +49.3%. This has been used because of the impact of the extraordinary event for the Change Healthcare and impact positively the dividends distribution + 12%. The 28/10/2016 MCK released the Q2 FY17 and earnings per share of $2.94 mismatched with investor's projection of $3.04 and plunge the Stock price to $124.11 the same day compared to 157.53 the previous one. Furthermore, by plotting a range on 1 price month performance we may observe an upward trend.

› **RATE OF RETURN:** The RRR is computed with the Capital Asset Pricing Model by using 5 years of historical data. The beta is computed with the S&P 500 index. And we may observe that the Beta moves to the Market beta.

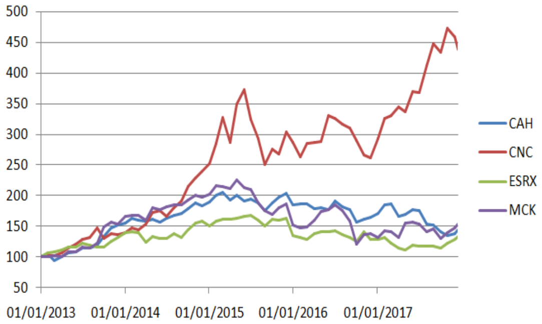
Variable	Value
Beta	1,16
Expected Return	9,09%
Risk Free Rate	2,14%
Sharpe Ratio	0,27
Unsystematic Risk	0,00468
Systematic Risk	0,00096
Required rate of return	10,18%

› **VOLATILITY:** The Volatility is highly sensitive to the MCK performance and management conferences call to shareholders. The correlation coefficient on returns remains high with the index, reaching 0.41. This could be potentially risky to include this stock in a portfolio if diversification not well managed.

DDM	2017	2018	2019	2020	2021	2022	TV
Dividends	1,24	1,36	1,48	1,62	1,78	1,95	282,24
PV	-	1,23	1,22	1,21	1,21	1,20	173,81

› The growth rate reaches 9.43% and has been found thanks to the geometric average of the 6 previous years of dividend distribution growth. The cost of equity is: 10.18% and allows to find with the DDM a predicted price of $132.60 up to 5 years against to $152. 59 (-$19.99). The stock price seems overvalued according to the model.

5 y – Price performance (Monthly)



Market Overview	Return Annualized	Volatility Annualized
CAH	-9,97%	19,42%
CNC	16,73%	30,10%
ESRX	-6,63%	19,77%
MCK	-10,91%	29,74%

MCK FY17

Variable	Value
Book Value Per Share	36,45
Net Earnings	5,1
Net Earnings	198,5
EBIT	7,1
EBITDA	11,3

Healthcare stocks – 24/2

Ticker Name	Stock Open Price (18/12/2017
Highest	
REGN	$387,19
ISRG	$360,56
HUM	$252,56
ALGN	$235,34
ANTM	$227,12
COO	$226,69
UNH	$223,75
BDX	$220,29
ILMN	$213,64
CI	$205,18
WAT	$197,09
TMO	$189,48
Lowest	
A	$66,68
XRAY	$66,13
BAX	$65,07
BMY	$62,57
CAH	**$61,00**
ABT	$55,03
HOLX	$43,40
MYL	$40,32
PFE	$36,78
PDCO	$35,85
EVHC	$33,15
BSX	$25,62

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VALUATION 2: RELATIVE MODEL

› Within this model by comparing some ratio of 58 Healthcare companies listed in the S&P 500, focusing especially on the following features, P/Sales – P/E – P/B – P/EBIT – P/EBITDA the more comparable companies are:

‹ CAH (Cardinal Health Inc) as seen above its specialized in healthcare solution, Logistics & Supplies.

‹ CNC (Centene Corp): specialized in Health insurance, services & support.

‹ ESRX (Express Script Holding Co): specialized in pharmacy management services.

MCK FY17	Book Value per share	Net Earnings	Revenues	EBIT	EBITDA
	36,45	5,07	198,53	7,11	11,28
	P/B	P/E	P/sales	P/EBIT	P/EBITDA
	2,9	7,5	0,2	5,9	5,2

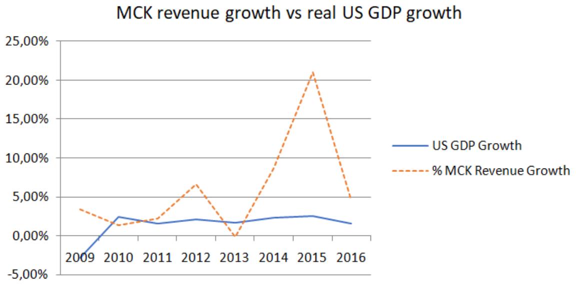
› Theses ratios are low compare to the majority of healthcare companies listed in the S&P500 index. The Net Debt reaches $5,762Bn (Debt of $8,545Bn and proportion of cash of 2,783 according to the IS)

Relative	P/B	P/E	P/Sales	P/EBIT	P/EBITDA
CAH	3	18,4	0,2	11,67	9,44
CNC	2,47	19,4	0,36	13,48	7,65
ESRX	2,55	11,9	0,41	9,94	7,09
Mean	**2,67**	**16,57**	**0,32**	11,70	8,06
Median	2,55	18,4	0,36	**11,67**	**7,65**

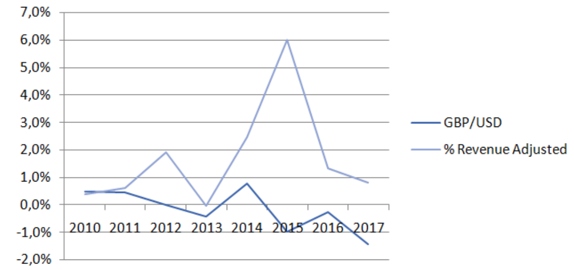
› Thus, the closest figures between the median and the mean to the MCK ratios are taken and we found a market range value of [58.43- 97.44] and an EV range of [64.19 – 103.21]. By choosing the biggest competitors as ABC/OMI/CAH within this model, the value would be overvalued.

› The comparables companies have a share price which is between $61 – $100.03. The lowest share price is for CAH, ESRX has a stock price of $71.25 and the highest price is for CNC the 18/12/2017 for the opening price.

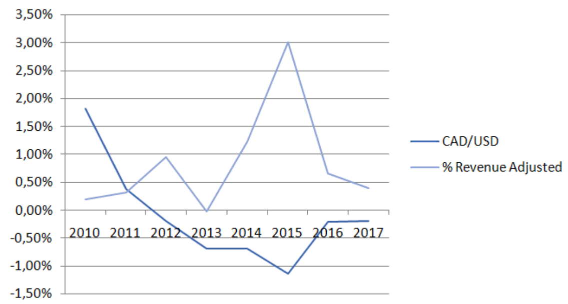
VALUATION 3: DISCOUNT CASH FLOW MODEL



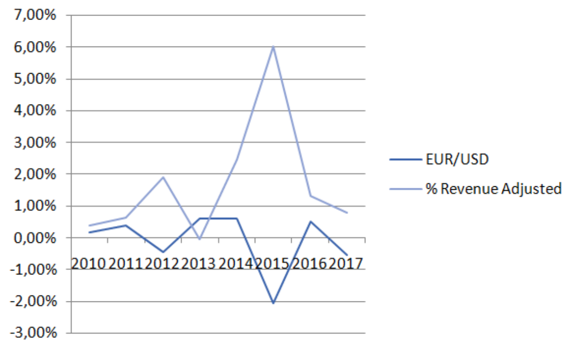
› **REVENUE GROWTH**: Revenue growth is not highly correlated with the market consensus with a correlation of 0.24. Revenue growth has been adjusted with 70% because of revenue generated on the US territory.
The number of Sales has increased significantly compare to the previous 2 years ($122Bn – 2013 / $137Bn – 2014 / $179bn – 2015) especially for the ten largest customers. These increases are due to February 2013 acquisition of PSS World Medica Inc. (PSSI) and February 2014 acquisition of Celesio AG. According to this growth revenues are forecast to follow a growth of 5.23 %



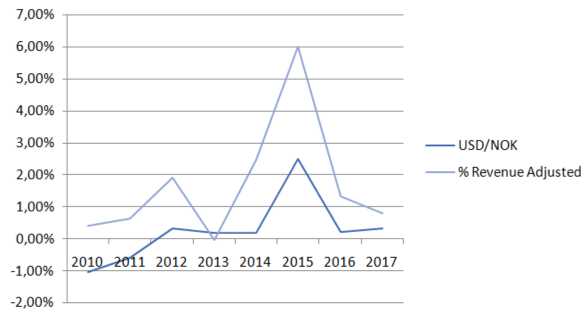
› **FOREIGN EXCHANGE EFFECTS ON REVENUE**: MCK's business is exposed in different countries and with a risk in FX appreciation/ depreciation; such as the EUR/USD, CAD/USD, USD/NOK and GBP/USD. The weight comparing to revenue is not the same, because 10% is generated in the Canada, 20% in the Europe.



‹ The most correlated is the USD/NOK reaching 0.88 against 0.80 for the EUR/USD. Which means that it's highly correlated because of the appreciation of the USD compare to others currencies over time. We may observe that due to the Brexit voted by referendum the 23 of June 201, results in a devaluation of the Pound Stirling. The Brexit could possibly impact negatively the business due to a possible increase in taxation because of the high cost of the exit from the EU.



‹ Some FX rate risk program have been implemented to reduce the risk of FX thanks to derivatives such as forward contracts and cross currency swaps and have a positive outcome.



DCF

DCF	2018 E	2019 E	2020 E	2021 E	
Revenue	208 952 €	219 919 €	231 460 €	243 608 €	
Cost of revenue	197 376 €	207 735 €	218 637 €	230 112 €	
EBITDA	11 576 €	12 183 €	12 823 €	13 496 €	
Total operating expenses	7 596 €	7 558 €	7 145 €	6 939 €	
EBIT	3 980 €	4 626 €	5 678 €	6 557 €	
Interest Expense + Other	327 €	320 €	268 €	268 €	
EBT	3 652 €	4 305 €	5 409 €	6 288 €	
Total tax	863 €	1 041 €	1 349 €	1 589 €	
Net income	2 379 €	2 828 €	3 594 €	4 198 €	
Capex	731 €	770 €	810 €	853 €	
Depreciation	437 €	465 €	0 €	0 €	
Working Capital	1 088 €	886 €	721 €	587 €	
PPE	334 €	277 €	229 €	190 €	
Net Borrowing	500 €	1 450 €		1 237 €	TV
FCFE	1 832 €	1 275 €	3 444 €	2 738 €	27 594,97

Forecasted Stock Price	**111,09**

› **KEY ASSUMPTIONS:** We have decided to forecast revenues with a growth of 5.25% for the next 4 years. Indeed, MCK is increasing acquisitions and is processing of the selling of low margin business such as the sale of the Brazilian pharmaceutical distribution. The Gross Margin remains stable over time with a rate estimated at 5.54%. The research and development is reduced because of the MCK's decision estimated at -9.02%. Even if the acquisition process is followed with rigor, the annual report and notes aren't suggesting a new acquisition. All the costs of acquisition are now delivered. So we have estimated a cost of 0 for FY18 but possibly a new acquisition for FY19, as the plan is well followed. Because of other operating expenses of $3.6Bn coming from the Change Healthcare company, and resulting of a positive impact in the EBIT we have estimated that it was an extraordinary event, and mustn't be recurrent. Restructuring expenses is followed until end of 2019 named the "Cost Alignement Plan". We are estimating similar expense for 2018 but higher in 2019 due to the Brexit estimated as $200m (split between UK and Ireland). The Interest Expense remains in a same area, 1.69% in average. Capex are not expected to grow. We have considerate to let the Capex at 0.35%as in 2017. The Working Capital is expected to decrease consistently as mentioned previously because of the "CAP". The growth is estimated of 2.62%, with a payout ratio of 13.09% and a ROA of 3% in average since 2009(the 2017 ROA hasn't counted) and a Ke of 10.18%. The EPS rate reaches 16.8% in average, related to the fact that MCK do many share buyback. The price Value reaches up to 5 years: $111.09 (i.e a potential loss of 27%)

› **CONCLUSION:** In the short term we have forecasted that the stock price will increase thanks to the good trend, and a good FY17. However in a long run, thanks to all Valuation Model, we forecast a decrease in the stock price up to 4 years or 5 years. We are suggesting holding the stock price until February but selling it before the FY18 in March. Thanks to comparable companies we have seen an overvaluation of the stock; the DCF analysis (thanks to all growth implemented) announce a decrease in the price. The UK is the biggest stake that will impact potentially the Business and so the stock performance in 2019. And according to the firm politic it's probable that some business would be sold to reduce the risk exposition.

Axel SATEGNA