



McKesson Corporation (MCK)

Updated October 28th, 2018 by Josh Arnold

Key Metrics

Current Price:	\$118	5 Year CAGR Estimate:	17.9%	Volatility Percentile:	75.1%
Fair Value Price:	\$188	5 Year Growth Estimate:	6.9%	Momentum Percentile:	17.0%
% Fair Value:	63%	5 Year Valuation Multiple Estimate:	9.7%	Growth Percentile:	61.1%
Dividend Yield:	1.3%	5 Year Price Target	\$262	Valuation Percentile:	95.1%
Dividend Risk Score:	B	Retirement Suitability Score:	D	Total Return Percentile:	90.4%

Overview & Current Events

McKesson Corporation traces its lineage to 1833 when its founders began to offer wholesale chemicals and pharmaceuticals in New York City. In the nearly 200 years since, McKesson has grown into a powerhouse in an ever-growing industry and today generates \$215 billion in annual revenue and trades with a \$24 billion market capitalization.

McKesson reported Q2 earnings on 10/25/18 and results were roughly in-line with expectations. Revenue increased 2% as strength in the Medical-Surgical segment offset ongoing weakness in Europe. McKesson is working to improve its performance in Europe, but structural headwinds remain in place. The core US Pharma segment produced 2% revenue growth and came in with operating margin at 1.53%. Total operating expenses fell 18% year-over-year, helping to produce \$2.51 in earnings-per-share against one penny of earnings in the year-ago quarter. McKesson narrowed its earnings guidance range during the Q2 report and we've slightly revised our estimate for this year to \$13.40 per share.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
EPS	\$4.58	\$5.00	\$5.83	\$6.33	\$8.35	\$11.11	\$9.84	\$11.61	\$12.62	\$12.62	\$13.40	\$18.70
DPS	\$0.48	\$0.72	\$0.80	\$0.80	\$0.92	\$0.96	\$1.08	\$1.12	\$1.30	\$1.30	\$1.56	\$2.30
Shares	271	271	252	235	227	231	232	225	211	202	200	180

McKesson's earnings-per-share history is quite robust, having grown YoY every year in the past decade with the exception of 2015. Indeed, even with that decline McKesson has managed to average 13.5% earnings-per-share growth annually over this time frame through organic revenue growth and many acquisitions. We do not believe that sort of growth is likely for the longer term as McKesson has grown much larger. As a result, it seems to have neared a plateau on operating margins and revenue growth, but we do see 6.9% in annual earnings-per-share growth moving forward.

McKesson will achieve this result largely via revenue gains, which we forecast will be in the 3% to 5% range for the foreseeable future. It continues to acquire growth in bolt-on acquisitions and in companies that supplement its current offerings, a strategy that should not change anytime soon. Margins have been flat for some time, so we expect that will continue, which means margins will not be driving any sort of significant earnings growth on their own. With that said, Q2 did see some operating leverage contribute to earnings growth; the company's still-new operations review seems to be bearing some early fruit. In addition, management recently increased its share repurchase authorization by \$4 billion, bringing the total to more than \$5 billion. That is good for a mid-teens percentage of the float at today's prices to that will certainly have the capability to drive significant earnings-per-share growth via a lower share count over time.

The dividend has never been a priority for McKesson and that is not likely to change anytime soon. We see the payout rising from today's \$1.56 to \$2.30 in five years, but the dividend remains just a small fraction of earnings.

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/E	11.2	11.8	13.6	13.8	14.9	16.8	17.9	20.1	14.1	12.0	8.8	14.0
Avg. Yld.	1.0%	0.9%	1.1%	1.0%	0.8%	0.7%	0.5%	0.5%	0.7%	0.5%	1.3%	0.8%

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The stock's price-to-earnings ratio has ebbed and flowed in the past decade but today, it is quite cheap relative to its historical norm at 8.8. We see fair value as 14 times earnings and thus, McKesson offers good value to prospective shareholders. That should provide a meaningful 9.7% tailwind to total returns over the next five years as the stock's valuation reverts to more normalized levels from today's trough. The yield should move back below 1% for the foreseeable future given the stock price appreciation we are forecasting and the diminutive payout.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
GP/A	4.7%	4.9%	5.1%	4.9%	5.2%	5.0%	4.7%	6.0%	5.8%	5.4%	5.4%	5.5%
Debt/A	75%	75%	73%	77%	79%	80%	80%	85%	84%	82%	82%	80%
Int. Cov.	7.5	8.4	11.0	9.1	9.2	10.0	8.7	8.6	10.8	25.8	30.0	40.0
Payout	10%	10%	13%	13%	13%	11%	9%	11%	10%	10%	12%	12%
Std. Dev.	37%	34%	19%	20%	15%	20%	14%	17%	32%	26%	25%	23%

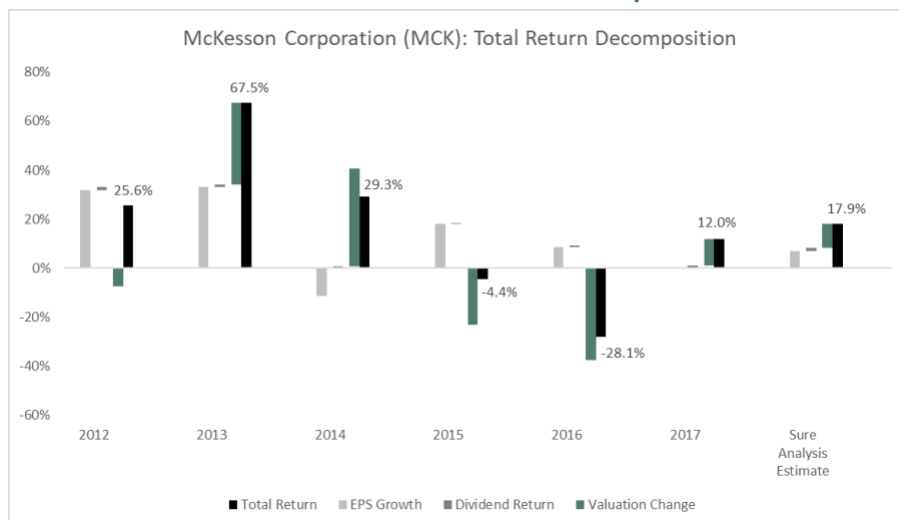
McKesson's quality metrics have been very stable for the past decade, having not moved much in one direction or the other. Margins have flattened out after slight deterioration a few years ago and we see a bit of potential for gains there over the long term given the company's operating review. Its balance sheet is reasonably leveraged, and the company's strong earnings mean it has more than ample interest coverage. The payout ratio will remain very low barring a material strategic shift, which we certainly are not forecasting. Overall, McKesson is in terrific shape financially.

Its competitive advantage is in its willingness to adapt and shift to the changing needs of its customers, its willingness to buy growth and its immense scale, which affords purchasing power. It should hold up well to the next recession given its product assortment that offers healthcare consumers things they need, and not discretionary items.

Final Thoughts & Recommendation

McKesson looks very attractive here as it offers a strong growth outlook, a robust share repurchase program and a valuation that is well under fair value. We are therefore forecasting 17.9% annual total returns going forward, consisting of the current 1.3% yield, 6.9% earnings-per-share growth and a 9.7% tailwind from a rising price-to-earnings multiple. That would make McKesson attractive for investors seeking growth or value, but its low yield would make it unattractive to investors seeking high levels of income. Overall, McKesson earns a buy recommendation at current prices.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue (\$B)	106.6	108.70	112.08	122.32	122.20	137.39	179.05	190.88	198.53	208.36
Gross Profit	5378	5676	5970	6402	6881	8352	11411	11416	11271	11184
Gross Margin	5.0%	5.2%	5.3%	5.2%	5.6%	6.1%	6.4%	6.0%	5.7%	5.4%
SG&A Exp.	3325	3312	3529	3727	4110	5388	7901	7379	7460	8138
D&A Exp.	441	148	496	493	581	735	1017	885	910	951
Operating Profit	1196	1988	2034	2273	2338	2507	3118	3645	3470	2921
Operating Margin	1.1%	1.8%	1.8%	1.9%	1.9%	1.8%	1.7%	1.9%	1.7%	1.4%
Net Profit	823	1263	1202	1403	1338	1263	1476	2258	5070	67
Net Margin	0.8%	1.2%	1.1%	1.1%	1.1%	0.9%	0.8%	1.2%	2.6%	0.0%
Free Cash Flow	959	1938	1950	2552	2083	2717	2567	2995	4182	3765
Income Tax	241	601	505	514	587	757	815	908	1614	-53

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	25267	28189	30886	33093	34786	51759	53870	56523	60969	60381
Cash & Equivalents	2109	3731	3612	3149	2456	4193	5341	4048	2783	2672
Acc. Receivable	N/A	7256	7982	9977	9975	13780	15914	17980	18215	17711
Inventories	8527	9441	9225	10073	10335	12986	14296	15335	15278	16310
Goodwill & Int.	4410	4353	5972	6782	8675	14798	13258	12807	14251	15026
Total Liabilities	19074	20657	23666	26262	27716	41441	45785	47515	49696	50324
Accounts Payable	N/A	N/A	N/A	16114	16108	21128	25166	28585	31022	32177
Long-Term Debt	2509	2296	4004	3980	4873	10594	9844	8114	8545	7880
Total Equity	6193	7532	7220	6831	7070	8522	8001	8924	11095	9804
D/E Ratio	0.41	0.30	0.55	0.58	0.69	1.24	1.23	0.91	0.77	0.80

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	3.3%	4.7%	4.1%	4.4%	3.9%	2.9%	2.8%	4.1%	8.6%	0.1%
Return on Equity	13.4%	18.4%	16.3%	20.0%	19.3%	16.2%	17.9%	26.7%	50.7%	0.6%
ROIC	9.9%	13.6%	11.4%	12.7%	11.8%	7.7%	7.6%	12.9%	27.4%	0.4%
Shares Out.	271	271	252	235	227	231	232	225	211	202
Revenue/Share	382.2	398.18	426.17	487.33	511.28	589.67	761.89	819.24	890.28	996.92
FCF/Share	3.44	7.10	7.41	10.17	8.72	11.66	10.92	12.85	18.75	18.01

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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