



McKesson Corporation (MCK)

Updated February 3rd, 2018 by Josh Arnold

Key Metrics

Current Price:	\$127	5 Year CAGR Estimate:	14.9%	Volatility Percentile:	72.3%
Fair Value Price:	\$176	5 Year Growth Estimate:	7.0%	Momentum Percentile:	17.6%
% Fair Value:	67%	5 Year Valuation Multiple Estimate:	6.7%	Growth Percentile:	65.2%
Dividend Yield:	1.2%	5 Year Price Target	\$266	Valuation Percentile:	90.4%
Dividend Risk Score:	C	Retirement Suitability Score:	F	Total Return Percentile:	86.2%

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 \$25 billion market capitalization.

McKesson reported Q3 earnings on 1/31/19 and results were uncharacteristically weak. Revenue was up 5% over the year-ago period, but adjusted earnings-per-share were flat at \$3.40. Gross margins were flat but operating expenses rose more quickly than revenue, driving operating margins lower during the quarter. Net income fell 7% on a dollar basis but an offsetting decline in the share count helped keep earnings-per-share at the same level.

McKesson's core US pharma business saw revenue rise 6% but operating profit fell 2% as operating margins continued their year-to-date decline against fiscal 2018. The story was largely the same for the European pharma business, which saw its revenue increase 1%, but operating profit declined 19% thanks to significantly lower operating margins. The Medical-Surgical unit was the lone bright spot as revenue gained 19% and operating profit rose 21%, posting a strong operating margin of 8.45% during the third quarter.

McKesson continues to return a lot of cash to shareholders, sending \$800 million back to owners in Q3 alone. Year-to-date, McKesson has spent \$1.4 billion on buybacks and just over \$200 million on the dividend. In addition, it has \$3.7 billion left on its current authorization, good for nearly 15% of the current outstanding stock.

McKesson narrowed its guidance range for full-year adjusted earnings-per-share to \$13.45 to \$13.65, and we've updated our estimate to \$13.55 in response.

Separately, McKesson announced the company's CEO, John Hammergren, would retire on 3/31/19 and that current President and COO Brian Tyler would take the top job.

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	\$13.55	\$19.00
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 nearly every year in the past decade. Indeed, McKesson has managed to average more than 10% 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 7.0% in annual earnings-per-share growth as sustainable 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 companies that supplement its current offerings, a strategy that is unlikely to change. 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. The buyback should continue to meaningfully reduce the float over time, which we see as a key driver of earnings-per-share growth.

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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	9.4	13.0
Avg. Yld.	1.0%	0.9%	1.1%	1.0%	0.8%	0.7%	0.5%	0.5%	0.7%	0.5%	1.2%	0.9%

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 9.4. We see fair value as 13 times earnings and thus, McKesson offers strong value to prospective shareholders. That should provide a robust 6.7% 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
Payout	10%	10%	13%	13%	13%	11%	9%	11%	10%	10%	12%	12%

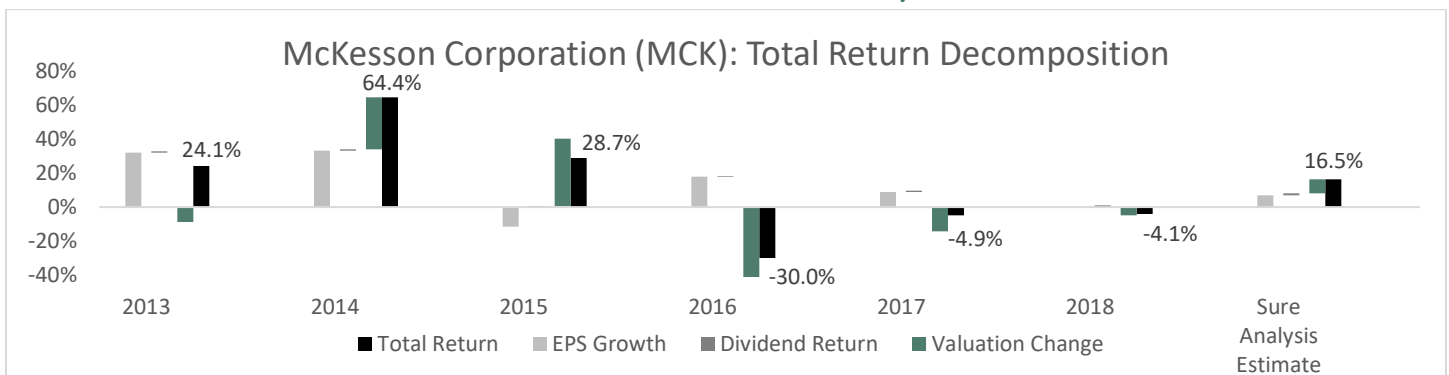
McKesson's quality metrics have been very stable for the past decade, having not moved much in one direction or the other. Margins have flattened out after slight deterioration a few years ago and we see a bit of potential for gains there over the long term given the company's operating review. Its balance sheet is reasonably leveraged, and 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 continues to look very attractive 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 14.9% annual total returns going forward, consisting of the current 1.2% yield, 7% earnings-per-share growth and a 6.7% tailwind from a rising valuation. 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 still earns a buy recommendation from Sure Dividend 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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