



# McKesson Corporation (MCK)

Updated August 20<sup>th</sup>, 2019 by Josh Arnold

## Key Metrics

<b>Current Price:</b>	\$146	<b>5 Year CAGR Estimate:</b>	9.4%	<b>Volatility Percentile:</b>	77.5%
<b>Fair Value Price:</b>	\$172	<b>5 Year Growth Estimate:</b>	5.0%	<b>Momentum Percentile:</b>	72.5%
<b>% Fair Value:</b>	85%	<b>5 Year Valuation Multiple Estimate:</b>	3.3%	<b>Growth Percentile:</b>	38.1%
<b>Dividend Yield:</b>	1.1%	<b>5 Year Price Target</b>	\$219	<b>Valuation Percentile:</b>	72.5%
<b>Dividend Risk Score:</b>	C	<b>Retirement Suitability Score:</b>	D	<b>Total Return Percentile:</b>	49.0%

## 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 186 years since, McKesson has grown into a powerhouse in the pharmaceutical and medical distribution industry and today, generates \$220+ billion in annual revenue and trades with a \$27 billion market capitalization.

McKesson reported Q1 earnings on 7/31/19 and results were strong, leading to a guidance increase for the full-year. Total revenue was up 6% to \$55.7 billion on a headline basis in Q1, and up 7% on a currency-neutral basis. The core US Pharma business saw revenue rise 8% to \$44.2 billion, primarily attributable to market growth, partially offset by branded-to-generic conversions. The European Pharma segment saw revenue decline 3% to \$6.7 billion on a headline basis, but up 3% on a currency-neutral basis, which was also driven by market growth. Finally, the Medical-Surgical business saw revenue rise 12% to \$1.9 billion, powered by acquisition activity.

Adjusted earnings-per-share came to \$3.31 in Q1, a 14% increase over the year-ago period. The gain was driven by higher revenue and a lower share count, but was partially offset by a higher tax rate.

Change Healthcare, which is McKesson's old Technology Solutions business, began trading in late June. Following the IPO, McKesson now owns 58.5% of the company, down from 70% pre-IPO. McKesson expects to receive ~\$260 million in adjusted equity earnings from Change Healthcare this year.

The company also spent \$684 million on share repurchases in Q1, while boosting its quarterly dividend 5% to 41 cents.

Finally, McKesson raised its earnings-per-share guidance to a new midpoint of \$14.30, and we've followed suit.

## Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
<b>EPS</b>	\$4.58	\$5.00	\$5.83	\$6.33	\$8.35	\$11.11	\$9.84	\$11.61	\$12.62	\$13.57	<b>\$14.30</b>	<b>\$18.25</b>
<b>DPS</b>	\$0.48	\$0.72	\$0.80	\$0.80	\$0.92	\$0.96	\$1.08	\$1.12	\$1.30	\$1.51	<b>\$1.64</b>	<b>\$2.38</b>
<b>Shares<sup>1</sup></b>	271	252	235	227	231	232	225	211	202	191	<b>185</b>	<b>170</b>

McKesson's earnings-per-share history is quite robust, having grown 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 still see 5% annual earnings-per-share growth as sustainable moving forward, which is a downward revision from the prior 7% estimate.

McKesson can achieve this result largely via revenue gains, which we forecast will be in the area of 3% 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. The buyback should continue to meaningfully reduce the float over time, which we see as a key driver of earnings-per-

<sup>1</sup> Share count in millions

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share growth. We've reduced our growth estimate due to an increasingly hostile regulatory environment for drug wholesalers like McKesson. In addition, constant pressure on pricing from regulators, as well as strong generic conversion are headwinds.

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 \$1.64 to \$2.38 in five years, but the dividend remains just a small fraction of earnings.

## Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/E	11.8	13.6	13.8	14.9	16.8	17.9	20.1	14.1	12.0	9.7	<b>10.2</b>	<b>12.0</b>
Avg. Yld.	0.9%	1.1%	1.0%	0.8%	0.7%	0.5%	0.5%	0.7%	0.5%	1.1%	<b>1.1%</b>	<b>1.1%</b>

The stock's price-to-earnings ratio has ebbed and flowed in the past decade but today, at 10.2 times earnings, it is cheap relative to its historical norm. We see fair value as 12 times earnings and thus, McKesson offers a reasonable value to prospective shareholders in our view. That could provide a 3.3% 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 remain about where it is for the foreseeable future.

## Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	10%	13%	13%	13%	11%	9%	11%	10%	10%	11%	<b>12%</b>	<b>13%</b>

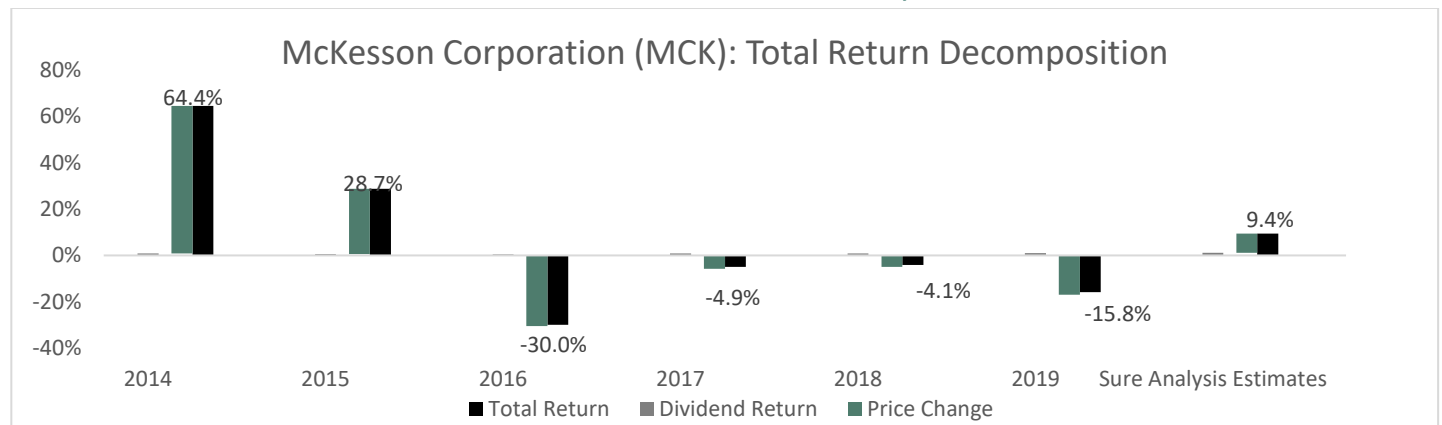
The payout ratio will remain very low barring a material strategic shift, which we are not forecasting. Instead, McKesson will almost certainly continue to boost earnings-per-share by reducing the float, as it did once again in fiscal 2019.

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. McKesson should hold up well during 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 attractive as it offers a decent growth outlook, a robust share repurchase program and a valuation that is still under fair value. We are forecasting 9.4% annual total returns going forward, consisting of the current 1.1% yield, 5% earnings-per-share growth and a 3.3% 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. Due to the reduced growth outlook, we're moving McKesson down to hold from buy.

## Total Return Breakdown by Year



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## Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
<b>Revenue (\$B)</b>	106.6	108.70	112.08	122.32	122.20	137.39	179.05	190.88	198.53	208.36
<b>Gross Profit</b>	5378	5676	5970	6402	6881	8352	11411	11416	11271	11184
<b>Gross Margin</b>	5.0%	5.2%	5.3%	5.2%	5.6%	6.1%	6.4%	6.0%	5.7%	5.4%
<b>SG&amp;A Exp.</b>	3325	3312	3529	3727	4110	5388	7901	7379	7460	8138
<b>D&amp;A Exp.</b>	441	148	496	493	581	735	1017	885	910	951
<b>Operating Profit</b>	1196	1988	2034	2273	2338	2507	3118	3645	3470	2921
<b>Operating Margin</b>	1.1%	1.8%	1.8%	1.9%	1.9%	1.8%	1.7%	1.9%	1.7%	1.4%
<b>Net Profit</b>	823	1263	1202	1403	1338	1263	1476	2258	5070	67
<b>Net Margin</b>	0.8%	1.2%	1.1%	1.1%	1.1%	0.9%	0.8%	1.2%	2.6%	0.0%
<b>Free Cash Flow</b>	959	1938	1950	2552	2083	2717	2567	2995	4182	3765
<b>Income Tax</b>	241	601	505	514	587	757	815	908	1614	-53

## Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
<b>Total Assets</b>	25267	28189	30886	33093	34786	51759	53870	56523	60969	60381
<b>Cash &amp; Equivalents</b>	2109	3731	3612	3149	2456	4193	5341	4048	2783	2672
<b>Acc. Receivable</b>	N/A	7256	7982	9977	9975	13780	15914	17980	18215	17711
<b>Inventories</b>	8527	9441	9225	10073	10335	12986	14296	15335	15278	16310
<b>Goodwill &amp; Int.</b>	4410	4353	5972	6782	8675	14798	13258	12807	14251	15026
<b>Total Liabilities</b>	19074	20657	23666	26262	27716	41441	45785	47515	49696	50324
<b>Accounts Payable</b>	N/A	N/A	N/A	16114	16108	21128	25166	28585	31022	32177
<b>Long-Term Debt</b>	2509	2296	4004	3980	4873	10594	9844	8114	8545	7880
<b>Total Equity</b>	6193	7532	7220	6831	7070	8522	8001	8924	11095	9804
<b>D/E Ratio</b>	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	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
<b>Return on Assets</b>	3.3%	4.7%	4.1%	4.4%	3.9%	2.9%	2.8%	4.1%	8.6%	0.1%
<b>Return on Equity</b>	13.4%	18.4%	16.3%	20.0%	19.3%	16.2%	17.9%	26.7%	50.7%	0.6%
<b>ROIC</b>	9.9%	13.6%	11.4%	12.7%	11.8%	7.7%	7.6%	12.9%	27.4%	0.4%
<b>Shares Out.</b>	271	271	252	235	227	231	232	225	211	202
<b>Revenue/Share</b>	382.2	398.18	426.17	487.33	511.28	589.67	761.89	819.24	890.28	996.92
<b>FCF/Share</b>	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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