VIOLA ADVISORY

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1Q18 Earnings: Drug Wholesalers (ABC, CAH and MCK)

TABLE 1: Drug Wholesalers Coverage

	Mkt. Price 6/8/18	Fwd. P/E	YTD	Viola Advisory Rating	Viola Advisory PT	Upside Potential 52-Week High	Upside Potential PT	Dividend Yield
ABC	86.09	11.9	-8.5%	Buy	95.00	23%	10%	1.65%
CAH	53.35	10.1	-15.6%	Buy	60.00	55%	12%	3.56%
MCK	145.37	10.0	-8.6%	Hold	155.00	23%	7%	0.93%

Source: Yahoo Finance, Estimize.com, YCharts.com and Viola Advisory LLC

TABLE 2: 1Q18 Earnings Results

	F2Q18 Results			FY18 Guidance			F2Q18 Results			FY18 Guidance		
	EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
ABC	1.94	1.82	beat	6.45-6.65	6.53	beat	41.0B	40.55B	in-line	165.4-170B	167.4B	in-line
	F3Q18 Results			**FY18 Guidance**			**F3Q18 Results**			**FY18 Guidance**		
	EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
CAH	1.39	1.51	miss	4.85-4.95	5.43	miss	33.6B	33.48B	beat	n/a	135.87B	n/a
	F4Q18 Results			**FY19 Guidance**			**F4Q18 Results**			**FY19 Guidance**		
	EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
MCK	3.49	3.56	miss	13.00-13.80	13.36	in-line	51.6B	51.25B	beat	218.8B	213.98B	beat

Source: Company earnings release and Estimize.com

Key Drug Wholesaler Metrics:

Pharmaceutical Distribution Services – ABC, CAH and MCK (Revenue Growth y/y)

FIGURE 1:

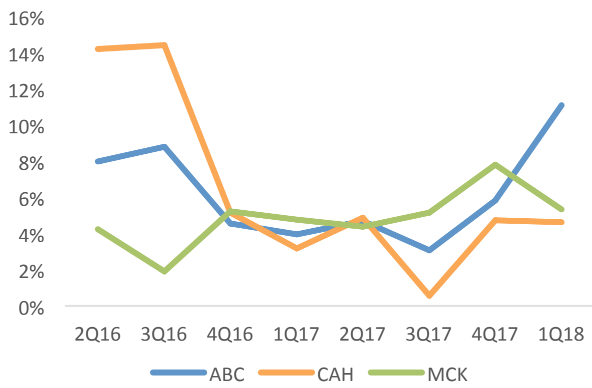

TABLE 3:

	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18
ABC	8%	9%	5%	4%	5%	3%	6%	11%
CAH	14%	14%	5%	3%	5%	1%	5%	5%
MCK	4%	2%	5%	5%	4%	5%	8%	5%

Source: Company earnings release

- The pharmaceutical distribution services is a critical revenue driver for drug wholesalers. The core business operations of a drug wholesaler occur in this business segment.
- For AmerisourceBergen (ABC), pharma distribution services make up roughly 96% of total revenue. For Cardinal Health (CAH) and McKesson (MCK), pharma distribution comprises around 88% and 83% of their total revenue, respectively.
- Figure 1 and Table 3 show the revenue growth for pharma distribution services. For AmerisourceBergen, it grew 11% y/y in 1Q18 while McKesson's pharma distribution revenue slowed sequentially from 8% y/y in 4Q17 to 5% y/y in 1Q18. Cardinal Health's pharma distribution services revenue remained flat sequentially at 5% y/y in 1Q18.

Gross Profit Conversion – ABC, CAH and MCK

FIGURE 2:

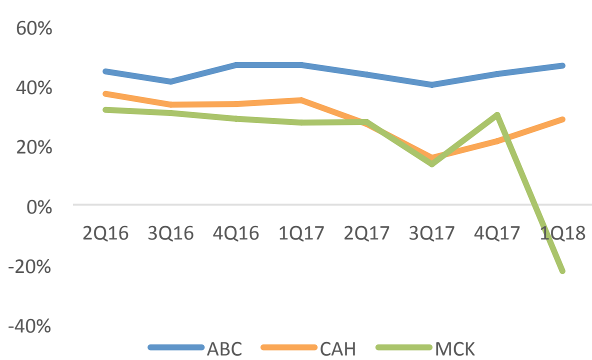

TABLE 4:

	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18
ABC	45%	41%	47%	47%	44%	40%	44%	47%
CAH	37%	34%	34%	35%	27%	16%	21%	29%
MCK	32%	31%	29%	28%	28%	14%	30%	-22%

Source: Company earnings release

- The substitution of brand-name drugs for generic drugs will reduce drug wholesalers' revenue growth, but wholesalers will still benefit significantly, since most of their profits come from generic drugs.
- Gross Profit Conversion metric shows how a wholesaler converts gross profits into operating profits (by reducing operating expenses). It shows operating income (EBIT) as a percent of gross profit (rather than revenue).
- For drug wholesalers, generic drugs yield more gross profit dollars per unit than brand-name drugs. Due to generic conversion, wholesalers can increase gross profits and at the same time, retain a greater share as operating income.
- Figure 2 and Table 4 show Amerisource-Bergen converted almost half (47%) of all gross profits into operating profits in 1Q18.

- McKesson had an operating loss of $666M in 1Q18 causing its gross profit conversion to drop to a negative 22%. Cardinal Health converted 29% of their gross profit into operating income in 1Q18, up from 21% in 4Q17.

I. AmerisourceBergen (ABC): Buy @ $95 PT

1Q18 Summary: We view AmerisourceBergen (ABC) as one of the best managed "pure play" drug wholesaler companies in the healthcare space. Revenue growth accelerated at the fastest pace in two years despite continued pricing and margin pressure in the prescription drug industry. More importantly, the company continues to be profitable, consistently converting close to half its gross profits into operating profits, a task not easily accomplished within the current environment of continued deflation of generic drug prices.

Additional Data Points:

- ABC grew 1Q18 quarterly revenues by a record pace in two years for its pharma distribution services (up 11% y/y) in 1Q18.

- Management stated increased generic volumes (despite continued generic price deflation) as well as outperformance in specialty distribution (oncology and physician-administered specialty drugs). Revenue growth in specialty distribution was up 12% y/y for 1Q18.

- Management also cited the earlier than anticipated on-boarding and integration of more than 1,900 Rite Aid stores into the Walgreens network in 1Q18. Management said the additional stores will have a full-quarter impact for both 3Q18 and 4Q18. Walgreens pharmacy (WBA) is AmerisourceBergen's largest customer.

- However, management also cited that lower hepatitis C revenues contributed to a higher than anticipated 120 bps revenue headwind for 1Q18.

- In addition, higher seasonal generic flu drug sales and stronger margins contributed meaningfully to 1Q18 operating income.

- Management maintained their overall FY2018 revenue guidance to between 8% to 11% growth. We view this as a very respectable growth rate given the continued pricing and margin pressure in the prescription drug industry.

- In terms of the generic pricing landscape, management indicated that they were encouraged by the stabilization of the generic deflation rate, but said it was still too early to factor an improvement into forward guidance.

II. Cardinal Health (CAH): Buy @ $60 PT

1Q18 Summary: We view Cardinal Health as an attractive entry point now that all the negative risks have been priced into the current price. Pharma distribution (88% of total revenue) continues to perform despite continued generic deflation and a competitive environment. Medical segment (12% of total revenue) still managed to grow nicely (up 15% y/y) compared to Pharma distribution (up 5% y/y) for F3Q18. Current headwinds at the Cordis business unit are mostly operational (and can be fixed) and

are not competitive. The sooner the global inventory problem is fixed (by the end of FY19), the sooner EPS visibility can potentially improve. This could set the stage for multiple expansion.

Additional Data Points:

- Cardinal Health's stock price dropped 21% after the latest F3Q18 report due to the underperformance of the medical segment (mostly the Cordis business) unit. CAH's medical segment distributes medical-surgical products and procedure kits (cardiovascular, wound management and orthopedic products) to hospitals, surgery centers, laboratories and physician offices worldwide.

- The underperformance of Cordis was mostly due to an earlier lack of inventory visibility outside the U.S. After CAH installed a global inventory tracking software, the company discovered excess inventory problems and a substantial amount of inventory with expired expiration dates. The excess and dated inventory resulted in pre-tax losses which reduced operating earnings. However, CAH could not apply these losses as a write-off against current income (probably due to the inventory coming from overseas) which consequently resulted in a higher effective tax rate.

- Non-GAAP EPS fell by 9% to $1.39 for F3Q18. Were it not for the Cordis tax issue, non-GAAP EPS would have been $1.52 for the latest quarter. Management expects the Cordis headwinds to be resolved by the end of FY 2019 (around June of 2019) where it expects Cordis to be on a path to profitable growth.

- We view the medical segment unit (12% of total revenue) as a value-added differentiator to CAH's pharma distribution portfolio. Moreover, the medical segment gives CAH an international platform where it can scale up and cross-sell its drug distribution business.

- Medical segment revenue is also growing at a faster pace (up 15% y/y) than pharma distribution revenue (up 5% y/y) for the latest F3Q18 quarter. Medical segment profit (up 34% y/y) also far outpaced pharma distribution profit (down 2% y/y) for F3Q18.

- Furthermore, despite the underperformance of the medical segment unit, Cardinal Health still managed to grow its gross profit conversion to 29% in F3Q18 from 21% in the previous quarter.

III. McKesson Corp. (MCK): Hold @ $155 PT

1Q18 Summary: We view McKesson as a well-managed company capable of competing effectively in the drug wholesaler space. However, near-term headwinds in the European market along with uncertainties from several large contracts coming up for renewal in CY2019 are keeping us on the sideline for now. We could become more positive in our outlook, depending on the outcome of some merger transactions that involve some of McKesson's largest customers.

Additional Data Points:

- Rite Aid (RAD) has been McKesson's second-largest customer since 2014, when McKesson assumed the purchasing and distribution of generic pharmaceuticals for Rite Aid. In 1Q18, Rite Aid successfully completed the transfer of 1,932 stores to Walgreens Boots Alliance (WBA). Consequently, McKesson's revenues from Rite Aid was expected to drop by more than 40% in 1Q18. This likely explains the reason why MCK's pharma distribution revenues slowed sequentially from 8% y/y growth in 4Q17 to 5% y/y growth in 1Q18.

- McKesson's retail pharmacy business in both the U.K. and Canada saw larger than anticipated prescription drug reimbursement cuts from both the U.K. and Canadian governments as well as minimum wage increases in Canada. This caused the company to recognize non-cash after-tax goodwill and long-lived impairment charges to its European businesses leading to a sizeable decline in operating income. This explains the large drop in its gross profit conversion metric for 1Q18 (see Figure 2 and Table 4 above).

McKesson has several large contracts coming up for renewal in calendar year 2019:

1. CVS Health Pharmacy. CVS Health is McKesson's largest customer. McKesson's agreement with CVS Health runs through June 2019. McKesson supplies CVS Health's mail and specialty pharmacies. CVS Health's specialty pharma revenue appears to be growing faster (+9% in 2017) than McKesson's specialty sales to CVS (+ 3.4%) during the same period. This may indicate that CVS Health could be reducing its dependence on McKesson.

2. Albertsons-Rite Aid merger. In February 2018, Albertsons (a longtime McKesson customer) announced its merger with Rite Aid. The merger will result in 4,300 pharmacies and a combined 2017 pro-forma prescription dispensing revenue of around $16B. However, Walgreen's earlier transaction with Rite Aid also grants Rite Aid the option to source drugs from Walgreens Boots Alliance Development (WBAD). The WBAD option expires in May 2019. If Rite Aid exercises its WBAD option, Albertson's generic procurement could shift to WBAD and its brand purchasing could shift to AmerisourceBergen.

3. Cigna-Express Scripts merger. Cigna is also a McKesson customer. Cigna operates mail and specialty pharmacies that rank among the largest in the U.S. If the Cigna-Express Scripts merger goes through, then both companies could consolidate their drug purchases with a single wholesaler. Cigna is projecting cost saving synergies from the merger. Express Scripts currently sources its drug purchases from AmerisourceBergen and from its own subsidiary.

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