VIOLA ADVISORY

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1Q18 Earnings: Retail Pharmacy / PBM

TABLE 1: Retail Pharmacy / PBM Coverage

	Mkt. Price 6/13/20/18	Fwd. P/E	YTD	Viola Advisory Rating	Viola Advisory PT	Upside Potential 52-Week High	Upside Potential PT	Dividend Yield
CVS	68.41	9.2	-7.0%	Buy	80.00	23%	17%	3.15%
WBA	63.91	9.9	-14.7%	Buy	80.00	31%	25%	2.47%
RAD	1.70	13.0	-20.2%	Hold	1.90	148%	12%	n/a
ESRX	81.77	8.6	8.7%	Hold	82.00	4%	0%	n/a
DPLO	26.41	23.4	25.7%	Buy	30.00	5%	14%	n/a

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

TABLE 2: 1Q18 Earnings Results

CVS	1Q18 Results			2Q18 Guidance			1Q18 Results			2Q18 Guidance		
	EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
	1.48	1.42	beat	1.59-1.64	1.42	beat	45.69B	45.79B	miss	45.8-46.6B	46.45B	miss

WBA	F2Q18 Results			F3Q18 Guidance			F2Q18 Results			F3Q18 Guidance		
	EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
	1.73	1.55	beat	n/a	1.49	n/a	33.02B	31.99B	beat	n/a	33.56B	n/a

RAD	F4Q18 Results			F1Q19 Guidance			F4Q18 Results			F1Q19 Guidance		
	EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
	-0.01	-0.02	beat	n/a	-0.03	n/a	5.39B	5.54B	miss	n/a	5.2B	n/a

ESRX	1Q18 Results			2Q18 Guidance			1Q18 Results			FY18 Guidance		
	EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
	1.77	1.76	beat	2.18-2.22	2.29	miss	24.77B	24.77B	in-line	99.0-102.0B	101.1B	miss

DPLO	1Q18 Results			FY18 Guidance			1Q18 Results			FY18 Guidance		
	EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
	0.20	0.22	miss	0.87-0.97	0.93	miss	1.34B	1.29B	beat	5.5B-5.9B	5.44B	beat

Source: Company earnings release and Estimize.com

Key Retail Pharmacy / PBM Metrics:

FIGURE 1: Gross Margins (left) and Comparable Front Store Sales (right)

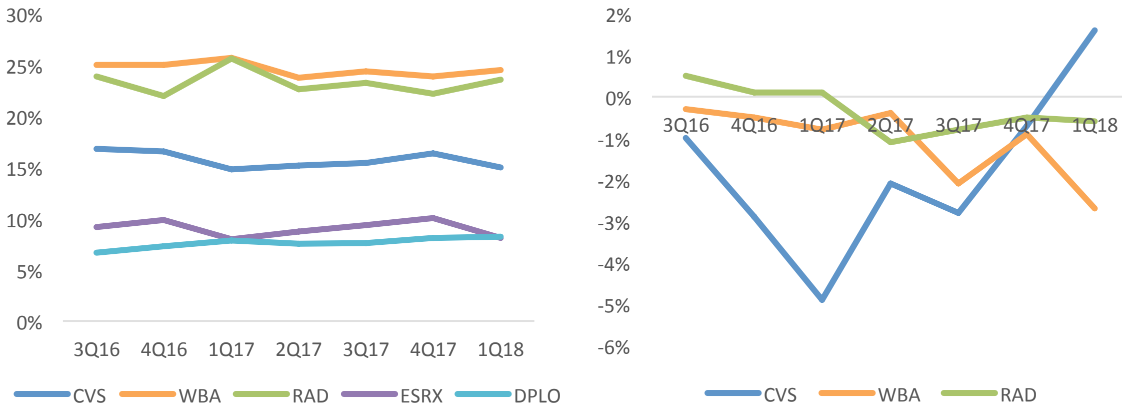


TABLE 3: Gross Margins (left) and Comparable Front Store Sales (right)

	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18
CVS	17%	17%	15%	15%	15%	16%	15%
WBA	25%	25%	26%	24%	24%	24%	25%
RAD	24%	22%	26%	23%	23%	22%	24%
ESRX	9%	10%	8%	9%	9%	10%	8%
DPLO	7%	7%	8%	8%	8%	8%	8%

	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18
CVS	-1%	-3%	-5%	-2%	-3%	-1%	2%
WBA	0%	-1%	-1%	0%	-2%	-1%	-3%
RAD	1%	0%	0%	-1%	-1%	-1%	-1%

Source: Company earnings release

FIGURE 2: Pharmacy Sales Growth (SSS) and Adjusted Prescription Volume (SSS)

TABLE 4: Pharmacy Sales Growth (SSS) and Adjusted Prescription Volume (SSS)

	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18
CVS	3%	0%	-5%	-3%	-3%	0%	7%
WBA	5%	2%	4%	6%	6%	7%	5%
RAD	-3%	-4%	-5%	-6%	-5%	-4%	-2%
ESRX	0%	-6%	-2%	0%	-4%	1%	-2%
DPLO	25%	16%	8%	3%	-5%	1%	24%

	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18
CVS	3%	2%	-1%	0%	0%	3%	9%
WBA	4%	3%	8%	8%	9%	9%	4%
RAD	0%	0%	0%	-1%	-2%	-2%	-2%
ESRX	6%	-27%	-1%	0%	-1%	0%	-3%
DPLO	9%	2%	-5%	-9%	-17%	2%	1%

Source: Company earnings release

I. CVS Health (CVS): Buy @ $80.00

1Q18 Summary: CVS's fundamentals seem to be on a rebound after several quarters of negative to flattish growth. This could be attributed to strong participation in Medicare Part D networks which may have driven script volume growth as well as comparable front store sales growth. We believe CVS's integrated model (PBM/retail drugstore) allows them to have first-mover advantage as the standard of quality healthcare shifts from volume-based to value-based care. The company has been on the forefront of developing pilot programs to manage and reduce healthcare costs for patients with common chronic diseases (i.e., diabetes, hypertension, hyperlipidemia, asthma and depression). If successful, we believe CVS can further expand and deepen their relationship with payers, PBMs and health provider groups who are also actively searching for ways to better manage and contain their healthcare costs.

Additional Data Points:

- After several quarters of negative growth, CVS's front store sales grew 2% y/y in 1Q18, making it the only retail pharmacy in the peer group to achieve positive growth (see Figure 1, right and Table 3, right).
- Comparable front store sales growth was driven by favorable positions in Medicare Part D networks, growing traction of Minute Clinic visits (fueled by the flu season in Jan., Feb. and Mar.), increased script growth and growing payer/PBM partnerships.
- Consolidated gross margins holding steady in the 15% to 17% range despite generic deflation, mostly supported by increased volumes in specialty pharmacy and continued adoption of CVS's Maintenance Choice program.
- Gross margin in Retail/LTC was 29%, down about 40 bps due to continuing pressure on reimbursement rate; however, the decline was partially offset by an increase in generic disbursement rate (GDR) and by improvements in the front store margin rate.
- Comparable adjusted script volume grew 9% y/y, the strongest growth rate in the retail pharmacy peer group for 1Q18. This in turn drove comparable pharmacy sales growth higher to 7% y/y in 1Q18, the second-best performer in the retail pharmacy space (see Figure 2 left and Table 4 left).
- Management believes Aetna transaction could close by 2H18 (towards year-end) which would bring about an expected $750M in synergies in Year 2 (by 2020).
- Due to the Aetna transaction, management has suspended the share repurchase program and will be keeping the dividend flat until the leverage ratio returns to normalized levels of 3x to 3.5x adjusted debt-to-EBITDA.

II. Walgreens Boots Alliance, Inc. (WBA): Buy @ $80.00

1Q18 Summary: We believe Amazon's decision to not enter the prescription drug distribution business removed a cloud of uncertainty in the drug supply chain space. We believe WBA remains undervalued at 10x next year's EPS and a dividend yield of around 2.50%. The company has a wide moat in the supply and distribution of generic drugs and has the potential to grow earnings once it completes its Beauty differentiation roll-out (2,900 stores so far) and expands its offering of in-store brands.

Additional Data Points:

- Both WBA and RAD have similar margin profiles probably due to their retail pharmacy business units which make up roughly 74% of total sales. CVS's retail pharmacy unit makes up around 38% of total sales.

- CVS's GMs are lower due to the greater presence of its PBM, CVS Caremark whose average GMs are in the mid-single digits.

- WBA's front-end sales dropped markedly in 1Q18 due to the planned reduction in the number of retail store SKUs. Management has been focused on growing retail store profitability and has streamlined the number of SKUs with below average margins and sales growth.

- CVS *Minute Clinic* may have a positive impact on script volume growth as well as contribute positively to its front-end sales growth. We believe both WBA and RAD could also benefit from this in-store clinic strategy.

- Despite the huge 1Q18 quarterly drop in WBA's script volume, WBA still outperformed the retail pharmacy group in script volume growth. The outperformance in script volume growth has led to WBA's above average pharmacy sales growth over the last 6 quarters which was also higher than both RAD and CVS.

- The drop in WBA's quarterly script volume in 1Q18 may have been due to share loss in the Medicare Part D market as well as substantial cuts in the CMS 340B Drug Discount Program which went into effect on 1/1/18.

III. Rite Aid Corp. (RAD): Hold @ $1.90

1Q18 Summary: We believe Rite Aid's merger application with Albertsons Supermarkets may be approved by the FTC, given the expiration of the Hart-Scott-Rodino (HSR) waiting period. The combined Rite Aid-Albertsons entity could make it the No. 4 pharmacy operator in terms of annual retail pharmacy sales (est. $16B). This would give Rite Aid's in-house PBM (EnvisionRx) the scale it needs to effectively compete with both CVS and WBA in both the Medicare Part D and the commercial payer markets. More importantly, it could also boost RAD's front-end store traffic and help grow prescription volume which could drive growth in pharmacy sales (26% of total sales).

Additional Data Points:

- Management announced the completion of the sale of 1,932 stores to Walgreens Boots Alliance, Inc.

- Retail pharmacy gross margins up 160 bps y/y due to improved generic drug purchasing and stabilization of reimbursement rates.

- Declines in retail pharmacy adj. EBITDA margins largely due to reimbursement rate pressure. Management sees a more stable adj. EBITDA margin environment for FY'19.

- EnvisionRx (RAD's in-house PBM) revenue growth down 300 bps y/y due to a decline in commercial business and changes in the composition of Medicare Part D membership.

- EnvisionRx gross margin of 7.0% is up slightly due to better generic pricing.

IV. Express Scripts (ESRX): Hold @ $82.00

1Q18 Summary: We recommend investors stay on the sideline for now as it appears ESRX might be having a difficult time competing for new business during the 2018-2019 selling season. We would be more constructive once we see an improvement in pharmacy sales growth and a steady growth in script volume. Furthermore, gross profit conversion seems to be declining, indicating the company is not operating at peak operating efficiency.

Additional Data Points:

- Pharmacy sales continues to remain stable but weak. Growth is mostly flat to negative over the last several quarters (see Figure 2, left). This indicates that ESRX is probably having a difficult time competing for new business. Going forward, competition will get tougher as the number of RFPs for the 2019 selling season is fewer compared to the current 2018 selling season.

- Script volume growth has also remained stable but weak over the last several quarters (see Figure 2, right).

FIGURE 3: Gross Profit / Adjusted Claim

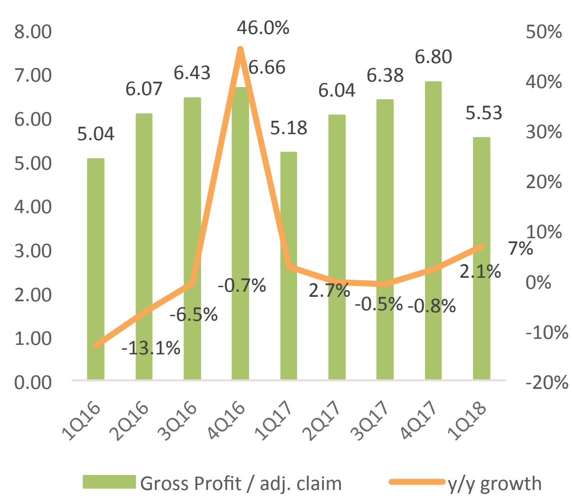
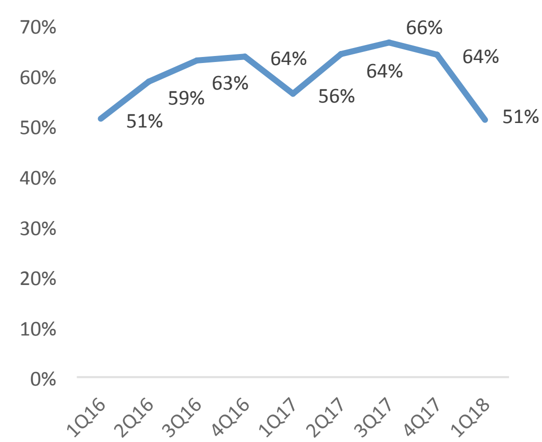


FIGURE 4: Gross Profit Conversion



Source: Company Earnings Release

- Gross profit per adjusted claim strengthened to 7% y/y in 1Q18 after mid-single digit to flat growth over the past several quarters (see Figure 3). Higher gross profit per adj. claim could be driven by a mix shift towards more specialty drug sales and less generic.

- Gross profit conversion seems to have peaked at 66% in 3Q17 and has since dropped to 51% in 1Q18 (see Figure 4). This indicates ESRX's operational efficiency seems to be slipping.

V. Diplomat Pharmacy (DPLO): Buy @ $30.00

1Q18 Summary: We believe Diplomat Pharmacy has two revenue growth drivers ahead of it: First, the high demand for specialty drugs and the growing trend for at-home medical services. At-home medical services represent the lowest cost for patient site of care compared to a physician or hospital setting. Because it is also more convenient for the patient, it increases the likelihood for medical plan adherence – an important factor in value-based care reimbursement. We also believe that the integration of Diplomat's in-house PBM, CastiaRx, could produce additional cost savings which may lead to higher EPS growth.

Additional Data Points:

- Diplomat's gross margin profile ranks the lowest among its peers within the retail pharmacy space (see Figure 1, left and Table 3, left). This is due to the high cost of specialty LDDs (limited distribution drugs) where its core business is based.

- After bottoming out in 3Q17, growth of pharmacy sales has strengthened significantly (up 24% y/y) in 1Q18 (Figure 2, left and Table 4, left) attributing to sales growth in its core business offerings: Oncology, immunology, neurology and at-home infusion drugs and services.

- Revenue from sales of LDDs comprises over 60% of specialty segment revenues, so Diplomat has a large footprint in LDDs.

- The planned integration of CastiaRx, its newly branded PBM, gives Diplomat the scale and access to LDDs that it can use to expand its relationships with patients, payers, pharmacies and physicians.

- CastiaRx's early stage integration has already delivered $1M in synergies offsetting the current 1Q18 costs. Management is projecting annualized synergies of $4M along with a total projection of $46M in synergies after the complete integration of CastiaRx.

- Script volume appears to be on a rebound (see Figure 2, right and Table 4, right). Unlike generic drugs, LDDs typically are not sold in large volumes, therefore access to a large selection of LDDs is necessary to maintain consistent growth in script volume. We believe script volume has more room to grow as additional LDDs in the market could be approved for expanded indications (bigger patient panels or more applications for the diagnosis and treatment of existing diseases).

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