

Amazon Enters the U.S. Drug Market: Implications for Retail Pharmacy / PBMs and 2Q18 Earnings

TABLE 1: Retail Pharmacy / PBM Coverage

	Mkt. Price 7/12/18	Fwd. P/E	YTD	Viola Advisory Rating	PT	Upside Potential 52-Week High	PT	Dividend Yield
CVS	67.99	9.2	-7.5%	Buy	80.00	24%	18%	2.96%
WBA	63.88	9.9	-14.8%	Buy	74.00	31%	16%	2.78%
RAD	1.65	21.4	-22.5%	Hold	1.90	155%	15%	n/a
ESRX	81.61	8.6	8.5%	Hold	82.00	4%	0%	n/a
DPLO	26.13	23.0	24.4%	Buy	30.00	6%	15%	n/a

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

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A. Amazon's Rationale for Buying PillPack

Amazon's \$1B cash deal (announced 6/28/18) to acquire online pharmacy PillPack gives it the ability to ship prescriptions to 49 U.S. states, excluding Hawaii, making it a direct threat to traditional retail pharmacies – CVS, Walgreens Boots Alliance and Rite Aid in the \$400B-plus pharmacy market.

PillPack currently focuses on a narrow segment of patients who are on many different medications. It packages pills in individual packets that help people remember when to take their drugs every day – a common challenge for people who have chronic conditions like diabetes, high cholesterol and high blood pressure. PillPack is still a niche player in the retail drug prescription market currently serving around 40,000 customers.

Amazon decided to acquire PillPack because it has the basic infrastructure that Amazon needs to enter the retail drug market: Mail-order pharmacy licenses in all 49 states, multiple pharmacy locations and a call center. Amazon also saw the potential of cutting out two pain points for the consumer – first, eliminate the inconvenience of visiting the pharmacy and second, reduce the stress of multiple medications by organizing them into packets and labeling them according to date and time of when to take them.

B. Consumer Sentiment for Amazon Pharmacy

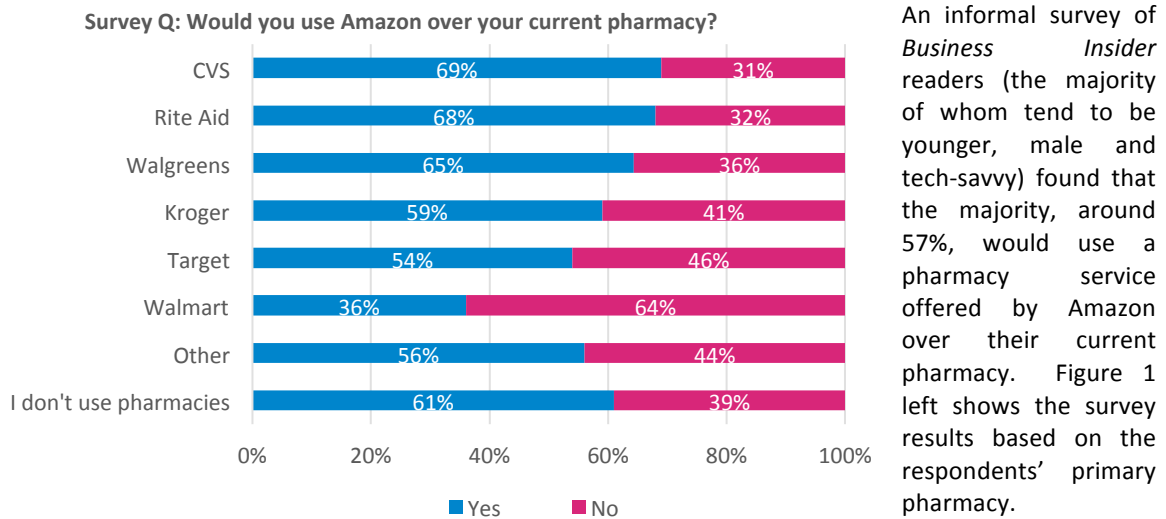
According to a report from *Global DataRetail*, most consumers welcome Amazon's entry into retail pharmacy. Around 54% of U.S. consumers approve of Amazon's decision most likely because they think it will increase competition and reduce drug prices. An estimated 24% of those surveyed felt the move was a bad decision while the remaining 22% took a neutral position. Approval was fairly even across the various demographic groups.

Additional Findings from Global DataRetail:

- Around 36% of consumers said they would either be very likely or likely to go to an Amazon pharmacy for their prescription needs.
- Almost 41% were not sure if they would use Amazon, mostly because of the networks permitted in their health insurance plans.
- About 61% would like Amazon to offer pharmacy services through mail order, but a large number would also like to see a physical presence, either at Whole Foods stores or through stand-alone pharmacies. This suggests Amazon might need retail pharmacies where customers can get medical advice or pick up their prescriptions to fully penetrate the pharmacy space.
- Almost 58% of consumers say they have a minor concern about sharing sensitive medical and health information with Amazon. However, almost 38% said they would have no problem at all (these consumers tend to be younger).
- About 79% of consumers would like Amazon to lower prices. Being able to pick up prescriptions from Whole Foods stores and have same day delivery were also popular. Just under 60% of consumers would like to re-order drugs from Alexa and 48% would like a discount for Prime members.

C. Traditional Retail Pharmacy – CVS, WBA and RAD – Face the Biggest Risk from Amazon

FIGURE 1: Amazon vs. Traditional Retail Pharmacy



Source: Business Insider Intelligence survey, n=1,020, 2Q18

- Figure 1 shows that traditional retail pharmacies like CVS, WBA and RAD face the greatest risk from Amazon's potential entry into the pharmacy space.
- Walmart also faces significant risk but its better positioned than its rivals – while 36% of respondents who identified Walmart as their primary pharmacy said they would switch, 64% said they would not switch.
- Even 61% of respondents who do not use a pharmacy could be enticed to try an Amazon pharmacy. This could represent a significant growth opportunity for Amazon.

Convenience could be the reason why two-thirds of Walmart customers said that they would not switch to Amazon. In many U.S. towns, Walmart serves as the one-stop shopping location for items, like groceries, that consumers would prefer to buy in-store. Filling a prescription at Walmart is already convenient since they already shop there.

Still, Amazon may have problems developing relationships with pharmacy benefit managers (PBMs) – the gatekeepers to most U.S. consumers who are covered by health insurance. PBMs could view Amazon’s entry as a threat and could delay any further moves by Amazon into the pharmacy market.

TABLE 2: 2Q18 Earnings Results

WBA	F3Q18 Results			F4Q18 Guidance			F3Q18 Results			F4Q18 Guidance		
	EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
	1.53	1.47	beat	n/a	1.47	n/a	34.3B	33.6B	beat	n/a	33.6B	n/a

RAD	F1Q19 Results			F2Q19 Guidance			F1Q19 Results			F2Q19 Guidance		
	EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
	-0.01	0.00	miss	n/a	0.02	n/a	5.39B	5.35B	beat	n/a	5.31B	n/a

Source: Company earnings release and Estimize.com

Key Retail Pharmacy / PBM Metrics:

FIGURE 2: Gross Margins (left) and Comparable Front Store Sales (right)

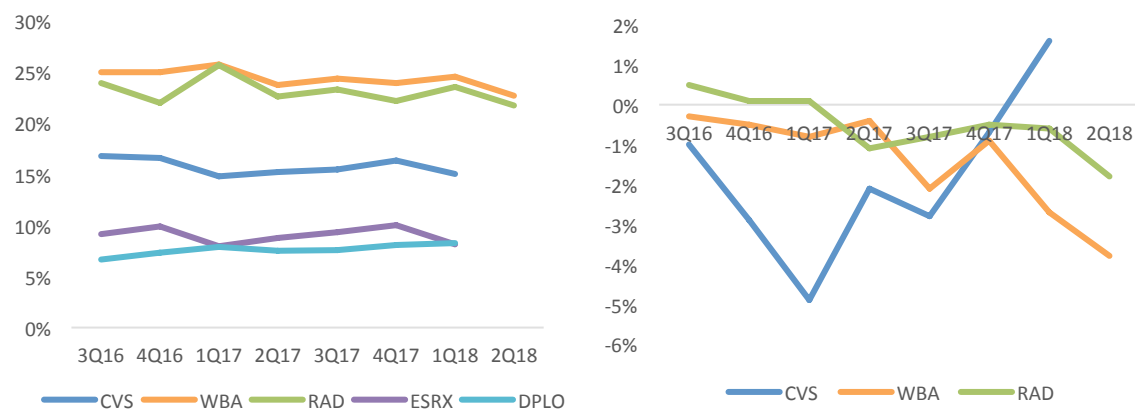


TABLE 3: Gross Margins (left) and Comparable Front Store Sales (right)

	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18
CVS	17%	17%	15%	15%	15%	16%	15%	15%	-1%	-3%	-5%	-2%	-3%	-1%	2%	2%
WBA	25%	25%	26%	24%	24%	24%	25%	23%	0%	-1%	-1%	0%	-2%	-1%	-3%	-4%
RAD	24%	22%	26%	23%	23%	22%	24%	22%	1%	0%	0%	-1%	-1%	-1%	-1%	-2%
ESRX	9%	10%	8%	9%	9%	10%	8%									
DPLO	7%	7%	8%	8%	8%	8%	8%									

Source: Company earnings release

FIGURE 3: Pharmacy Sales Growth (SSS) and Adjusted Prescription Volume (SSS)

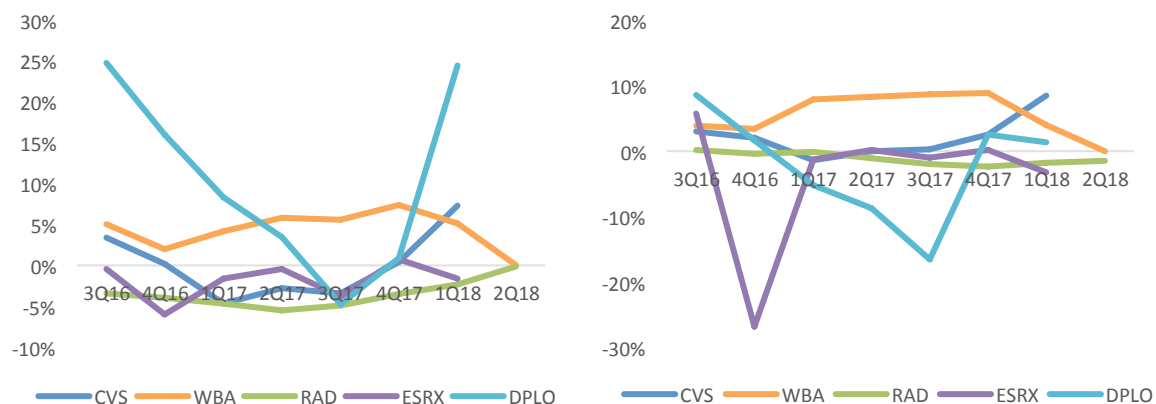


TABLE 4: Pharmacy Sales Growth (SSS) and Adjusted Prescription Volume (SSS)

	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18		3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18
CVS	3%	0%	-5%	-3%	-3%	0%	7%		CVS	3%	2%	-1%	0%	0%	3%	9%	
WBA	5%	2%	4%	6%	6%	7%	5%	0%	WBA	4%	3%	8%	8%	9%	9%	4%	0%
RAD	-3%	-4%	-5%	-6%	-5%	-4%	-2%	0%	RAD	0%	0%	0%	-1%	-2%	-2%	-2%	-2%
ESRX	0%	-6%	-2%	0%	-4%	1%	-2%		ESRX	6%	-27%	-1%	0%	-1%	0%	-3%	
DPLO	25%	16%	8%	3%	-5%	1%	24%		DPLO	9%	2%	-5%	-9%	-17%	2%	1%	

Source: Company earnings release

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

2Q18 Summary: TBD

II. Walgreens Boots Alliance, Inc. (WBA): Buy @ \$74.00

2Q18 Summary: We are maintaining our Buy rating but reducing our PT from \$80 to \$74 given the growing uncertainties in both the retail pharmacy channel and the 340B Drug Discount Program. Amazon’s entry in the retail drug space via PillPack could gradually take share from WBA’s customer base, especially the uninsured who pay out-of-pocket for brand name prescription medicine. Also noteworthy is the 340B Program which WBA has significant exposure to (34% market share of an estimated \$16B market size in 2016). HHS Secretary Alex Azar has been calling for increased oversight of contract pharmacies and reforms which will likely lead to more reductions in Federal subsidies and reimbursements to covered entities.

We believe it will take some time before Amazon can significantly scale up the PillPack business, but one thing is for certain, more brand name drug prices will come under increasing pressure and with it, less room for profit margin growth. It remains to be seen how management can shore up margins besides the shift in product mix to more in-store brand and beauty and wellness. Management needs to grow retail traffic in order to boost front-store sales. We believe WBA will begin to add more higher value healthcare services (eye and ear exams, in-store clinics, nutritionists working closely with pharmacists for more holistic health care, etc.) in the front of the store in order to grow margins and diversify their revenue streams.

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

2Q18 Summary: We believe the upcoming Rite Aid shareholder meeting on Aug. 9th will decide whether or not the company can have a sustainable business model capable of defending itself against Amazon's entry into the retail drugstore space. We believe a shareholder vote for merging with Albertsons is a favorable outcome because it produces a combined company similar to Walmart (a national supermarket chain with an integrated pharmacy). A shareholder vote against the Albertsons merger leaves Rite Aid as a regional pharmacy without a defensible moat or a scalable platform that could prevent Amazon from taking share. We believe the RAD/Albertsons merger has a good chance of obtaining regulatory approval by the DOJ, but we are not sure whether it will gain shareholder approval.

Retail front-store sales weakened in 2Q18 (down 2% y/y) but same store pharmacy sales continue to strengthen despite the flat script volume. The pace of wellness store remodels continues to grow with more than two thirds of the entire store network (almost 1,700 wellness stores) already completed. Wellness stores continue to outperform in terms of front-end same store sales and script count. We believe wellness stores represent the best line of defense against Amazon because it motivates customers to visit the store (for expanded healthcare offerings, medical advice, health screenings, etc.) and to remain loyal to the brand.

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

2Q18 Summary: *TBD*

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

2Q18 Summary: *TBD*

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