Executive Summary

McKesson Corporation (NYSE:MCK)

referred to as ("MCK")

Section 2 Group 6

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As of

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McKesson Corporation.

Analysis of Value Investment Criteria

MCK is not obscure due to a large market cap of $31.4bn and high analyst coverage. However, the company's **P/E is 7.6x**, and despite the high M/B of 2.3x, it is trading near **the 52-week low** at $139.04. MCK operates in **a non-cyclical attractive** industry. Management does not own a large portion of shares; however, MCK has repurchased a third of its stock over the past decade and has been increasing dividend. MCK's market share of 39% indicates a moat arising from **sustainable competitive advantages** and barriers to entry through economies of scale and demand advantage. The company is conservatively levered in comparison to its competitors. We believe MCK has a large franchise value, therefore have taken a **Buffett approach** to relax the obscurity criteria and continued our research.

Analysis of Industry and Company

Business Risk: MCK is the **largest** North American pharmaceutical distribution company. The industry is a **triopoly** with 90% of the market controlled by 3 players and has experienced a stable growth in the past 10 years that is expected to continue between 4 to 7% CAGR with an aging population. Companies within the industry compete on **low cost services**, **marketability**, and **operating efficiencies**. Recently, consolidation in the retail market has put pressure on distributors' margins. MCK is the largest distributor in the industry and has the cost advantages over its competitors due to it's scale. Therefore, we assess the business risk to be **Medium-Low**.

Financial Risk: To be conservative, medium business risk is assumed and the optimal capital structure is between **30 and 49%**. The target capital structure is assessed to be **45.7%**, using the average of last 8 years as it has been relatively stable and within the optimal range. We believe that the management is maintaining a conservative capital structure, compared to its competitors, to stay alert for future acquisition opportunities. We assess MCK's financial risk to be **Medium.** The medium business risk and medium financial risk suggest a credit rating range of **A-BBB**, which is consistent with the current credit rating indication of **BBB+**.

WACC: A pre-tax K_d of **3.98%** is acquired by taking the weighted average of A and BBB bond yields by 30% and 70%, respectively. K_s of **8.98%** is acquired with the corresponding ERP of **5%**. With a marginal tax rate of 38.1%, a WACC of **7.68%** was obtained.

1st Pass ROIC: The 1st pass ROIC is 9.0%, **exceeding the WACC** by 3.0%. However, it has been trending downwards with restructuring and pricing trends. ROIC over WACC indicates that EPV may be higher than NAV, however, NAV must be considered for the 2nd pass.

Valuation

NAV: The calculated NAV/Share is **$124.58**. The major drivers for NAV are **accounts receivables** (25%), **inventories** (23%), **hidden assets** (18%), and **Goodwill and intangibles** (17%). High AR is not a concern as it is comprised of broad number of customers, and days of AP exceeds days of AR by **25.6 days**. High inventory level is consistent with the industry and not a concern due to its **long shelf life**. High intangibles are as expected with the matured industry and MCK's nature of the business. For the I&A, refer to the exhibits.

EPV: An EPV/Share of **$157.44** was obtained. EBIT margin of **1.87%** was used, the average between 2010 & 2016, as the management has been able to recover and stabilize around 1.8% with the margin pressures in the past. Zero growth CAPEX is set equal to D&A as the total CAPEX is about half of total D&A. As the probability of sustaining the franchise is high, we implied a multiple of **80%**.

2nd Pass ROIC: The 2nd pass ROIC is 6.74%, yielding a small spread over WACC by **0.71%**. However, MCK's **high asset turnover** and relatively **high operating leverage** must be considered. A potential value of the franchise is calculated to be **$32.85/Share**.

Strategic Valuation

Management: The management strategy has been focused on acquiring reverent companies to protect their market share as well as increasing switching costs through a strong customer relations and joint ventures. The CEO also has a strong record of operations, evident in stabilized margins, and consistently distributes value through share buybacks and increase in dividend payments.

Government: The government has created strict regulations regarding drug safety. This makes it difficult for competitors to enter in to the market as they will have to comply with government regulations and gain licences to distribute pharmaceutical products.

Barriers to Entry: Distribution centers create economies of scale advantage as the cost of operations decreases with higher unit sales. Furthermore, significant barriers to entries are created though diverse product portfolios and substantial customer relations, increasing the switching costs. Because MCK is the largest in the market and for the reasons above we assess that there is a franchise value.

Value of Growth

Conditions for Growth: CAGR of EPS is **11.99%**, EBIT/Share **6.71%**, and Rev/Share **7.96%** between 1993 to 2018. All three indicators are above inflation (spread between 2~5%), showing promising **signs of growth**. With real growths, higher 2nd pass ROIC over WACC, and high sustainability of the franchise, **conditions for growth are met** and can proceed with the calculations.

Value with Growth: Zero growth EPV/Share of **$181.85** is acquired, yielding the 3rd pass ROIC of **7.6%**. Nominal growth required for 1.5 VGM is calculated to be **4.27%**. We believe MCK is unlikely to achieve such growth and proceeded with growth calculations by multiplying the normalized reinvestment ratio and the 3rd pass ROIC. The minimum real growth rate of **0.85%** is acquired by dividing growth R&D and marketing expenses by NOPLATPA, and the maximum rate of **1.48%** is acquired by including the growth CAPEX in the calculation. With the lower bound inflation of 2% and the minimum growth rate, value with growth of **$215.42/Share** is calculated.

Intrinsic Value and Recommendation

$$\text{IV}\ (\textbf{No Growth}) = 124.58 + 0.8 * (157.44 - 124.58) = \$\mathbf{150.87} \qquad \text{IV}\ (\textbf{Growth}) = \$\mathbf{181.85}$$

$$\text{EP} = 181.85 * 1.185 * \left(\frac{2}{3}\right) = \$\mathbf{143.61}$$

The **Calculated Entry Price is $143.61.** The **Market Value is $139.04** as of March 25th, 2018. We recommend **buying** at this price.