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CVS Caremark Feeling the Heat

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Last summer, the Miami Heat won a fierce free agent battle to sign LeBron James, arguably the best basketball player on the planet. He was to be teamed with the Heat's incumbent superstar, Dwyane Wade, one of the most dynamic players in the league. Fans dreamed of James and Wade wreaking havoc on the rest of the NBA. Talk of multiple championships and "Best Team Ever" accolades echoed throughout the sports media. The hype reached a crescendo just before the season started when players celebrated like they had already won the title.

When the Heat lost 7 of their first 13 games and the on-court chemistry faltered, most of the national media wrote off the team's chances.

Sometimes the sports world is mirrored by the business world.

In the spring of 2007, CVS (CVS), the large retail pharmacy chain, won a hotly contested battle to buy Caremark, a leading pharmacy benefits manager (PBM). Bulls imagined the great purchasing power the combined company would have over pharmaceutical companies and drug distributors.

Reality set in in 2009 when service problems at Caremark led to billions in lost corporate contracts. In reaction, the stock has trailed the returns of the S&P 500 and its largest rival, Walgreens (WAG).

Just as the Miami Heat slowly turned its season around, CVS Caremark's business is also picking up. ROC, ROA and profit margins are all increasing. Inventory turnover, a key retail metric, is now higher than WAG's, the more efficient operator. Revenue growth at the CVS retail segment over the last three years has averaged 8.3% vs. 8% for WAG. As seen in the table below, CVS Retail compares favorably with WAG, which commands a 12x Enterprise Value to EBIT (Earnings before interest and taxes) multiple.

Retail Pharmacy Comparison- FY 2010

	WAG	CVS Retail
Revenue ($B)	$67.4	$57.3
EBIT ($B)	$3.4	$4.5
Operating Margin %	5.0%	7.9%
EV/EBIT	12x	n/a

While the Caremark division has taken a hit, it has secured new contracts this year and like its retail counterpart will benefit from the wave of drug patent expirations over the next couple of years. In addition, the company's Maintenance Choice program, allowing Caremark customers to pick up prescriptions at their local CVS, is increasing penetration, driving more business to the stores. Despite being a little smaller than its largest competitors, Express Scripts (ESRX) and Medco Health Services (MHS), the Caremark division delivered the highest margins in the group. At recent prices, ESRX and MHS sell for an average of 13x EV/EBIT.

PBM Comparison- FY 2010

	MHS	ESRX	Caremark
Revenue ($B)	$66.0	$45.0	$47.8
EBIT ($B)	$2.5	$2.1	$2.4
Operating Margin %	3.8%	4.6%	5.0%
EV/EBIT	11x	15x	n/a

When comparing its separate divisions to the nearest competitors, CVS is undervalued. At its recent price, CVS had a total Enterprise Value (market value of equity + debt – cash) of $59B. Its retail division has $4.5B in operating income (or EBIT). Applying the 12x EV/EBIT multiple that the market gives WAG would value the retail division at $54.4B, so