S&P Focus Stock of the Week

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Monday May 30, 2011 (10:00 AM EDT)
CVS CAREMARK CORPORATION (CVS)

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NOTE: Due to the Memorial Day holiday, there will not be a Focus Stock published the week of May 30th.

INVESTMENT THESIS This week's Focus Stock of the Week is CVS Caremark Corporation (CVS: $38), which carries Standard&Poor's highest investment recommendation of 5-STARS, or Strong Buy.

We believe CVS is well positioned to benefit as an operator of one of the largest retail drugstore chains (based on store count, revenues and net income) and one of the largest pharmacy benefit management (PBM) businesses in the U.S. (based on lives covered). We see profitability accelerating in the intermediate term as favorable industry trends, which include an aging U.S. population, increased generic drug utilization and growth of specialty pharmacy services, likely result in higher demand and margin expansion opportunities. Additionally, we believe the company will experience significant benefits from health care reform, as we think greater numbers of people receiving health care coverage are more likely to determine shopping destination based on convenience rather than price.

Despite our expectation for a slowdown in EPS growth in 2011, we believe steps CVS has taken to correct near-term company-specific issues position it well to experience a significant acceleration in EPS growth in 2012.

We have confidence new management will take the necessary steps to reaccelerate growth. Larry Merlo succeeded former CEO Tom Ryan (CVS CEO 1994-2011) on March 1, 2011. Merlo's transition to CEO, from company president, began in 2010. He has significant experience in the retail pharmacy business having begun his career as a pharmacist, and has over 20 years of experience with CVS, which involved the integration of many large-scale retail drugstore acquisitions, including Longs Drug Stores in 2008, Osco/Sav-On in 2006, and Eckerd in 2004.

Meanwhile, Per Lofberg was named president of the company's pharmacy services segment in January 2010, following a loss of market share for the PBM business after Caremark's integration with CVS. After stabilizing the business in 2011, Lofberg should lead a recovery in growth within this segment in 2012, in our view. He has over 30 years experience in health care and the PBM industry and was formerly chairman of the company that is known today as Medco Health Solutions (MHS 64 Strong Buy), the largest PBM in the U.S.

During the company's first-quarter EPS conference call on May 5, 2011, CEO Merlo addressed what he referred to as speculation in the media and in the investment community regarding the future direction of the company. If there were any doubts about CVS's plans for its two distinct operating segments, we believe Merlo erased them when he started the call stating he had no plans to split up the company. CVS's plans for turning around the PBM business includes new client wins, developing and upselling the company's clinical offerings, growing its Maintenance Choice program and generic dispensing rates, focusing on its high-growth areas (Medicare Part D, specialty pharmacy and new Aetna (AET 45 Buy) contract), while cutting costs through an ongoing PBM streamlining initiative.

Lofberg will be focused on winning new PBM clients by stressing how CVS can save clients money through its unique programs. We expect the company to experience a significant sales boost following the successful signing of Aetna to a 12-year contract with $9 billion in annual spending. We expect this contract to be only modestly accretive to EPS in 2011, contribute an additional $0.05 per share to EPS in 2012, and over $0.10 to 2013 EPS.

Lofberg is also leading a streamlining initiative to improve workflow and align the company's cost structure more closely with peers. This initiative is designed to generate over $1 billion in cost savings by 2015.

All told, we believe favorable industry trends combined with new management's leadership will result in a significant acceleration in EPS growth beginning in 2012.

BUSINESS PROFILE Rhode Island-based CVS Caremark Corp. operates not only one of the top two largest drugstore chains in the U.S. (based on revenues, net income and store count), but also one of the top three largest pharmacy benefit managers (PBM). CVS drug stores offer prescription drugs and a wide assortment of general merchandise, including OTC drugs, beauty products and cosmetics, film and photo finishing services, seasonal merchandise, greeting cards and convenience foods. The company's pharmacy benefit management offerings include mail order pharmacy service, specialty pharmacy services, plan design and administration, formulary management and claims processing. Clients include insurance companies, government employee groups, managed care companies, unions and other sponsors of health benefit plans. During 2010, the company filled approximately 636 million prescriptions, or about 18% of the U.S. retail pharmacy market.

CVS is also the largest operator of retail health care clinics. As of December 2010, it operated 560 retail health care clinics in 26 states under the MinuteClinic name, which diagnose and treat minor health conditions, perform health screenings, monitor chronic conditions and deliver vaccinations. The company plans to open 100 new clinics annually over the next five years.

CVS's long-term strategy focuses on utilizing its integrated pharmacy benefit management and retail store model to improve consumer care and reduce health care costs. Under this strategy, CEO Merlo is shifting the role of pharmacists from primarily distributing medications, to also providing services, including flu vaccinations, as well as face-to-face patient counseling with respect to adherence to drug therapies, closing gaps in care and more cost-effective drug therapies.

Within its pharmacy services business segment, the company's goal is to provide innovative pharmaceutical solutions and quality client service in order to enhance clinical outcomes for its clients' health benefit plan members while assisting its clients and their plan members in better managing overall health care costs. With its integrated pharmacy services model, the company strives to utilize its multiple customer touch points (mail order, retail locations, specialty pharmacies, retail clinics, call centers and proprietary websites) to engage plan members in behaviors that lower cost and improve health care outcomes. Examples include programs such as Maintenance Choice, where eligible members in plans sponsored by pharmacy services clients can elect to fill their maintenance prescriptions in retail stores instead of receiving them through the mail; and Pharmacy Advisor, a program that facilitates face-to-face counseling by pharmacists to plan members.

Historically, the company has grown, in large part, through acquisitions. In October 2008, CVS bought Longs Drug Stores for about $2.9 billion in cash. Acquisitions have made the company the largest drugstore retailer in California and Hawaii and expanded its footprint in Arizona and Nevada. In March 2007, the company acquired Caremark Rx for about $26.5 billion in stock and a cash dividend. The acquisition combined two of the largest pharmacy benefit managers in the U.S. In June 2006, CVS acquired 700 stand-alone drugstores from Albertson's for $2.93 billion in cash. In July 2004, it bought 1,268 Eckerd drug stores, as well as Eckerd's mail order, specialty pharmacy and PBM businesses, from J.C. Penney (JCP 36 Hold) for $2.15 billion.

CVS operated about 7,200 stores, as of December 2010, in 41 states, Puerto Rico and the District of Columbia. As of December 2010, the company had stores in 92 of the top 100 U.S. drug store markets, holding the number one or number two market share in 72 of these markets. Pharmacy operations are critical to CVS's success, in our view, accounting for 68% of retail store sales in 2010. Payments by third-party managed care providers under prescription drug plans accounted for 97% of retail pharmacy sales in 2010. CVS's pharmacy benefit management business generated $47.8 billion of sales in 2010, or 45% of total company sales (excluding intersegment eliminations). The company's specialty pharmacy business operates 44 retail specialty pharmacy stores and 18 specialty mail order pharmacies.

COMPANY OUTLOOK We see consolidated sales rising 12.5% in 2011, to about $108 billion, from $96.4 billion in 2010, reflecting the signing of new pharmacy benefit management clients, retail drug store comparable store sales growth of 3.5%, and net new square footage growth of about 2.5% (including the opening of 225 to 250 new stores). Our estimate includes an estimated $900 million associated with the April 2011 acquisition of Universal American Corp.

We see margins narrowing significantly this year, reflecting increased pharmacy drug reimbursement pressures, significant costs related to efforts to streamline the PBM segment, and a change in business mix within the PBM segment (reflecting the lower-margin Aetna contract and the fall extension of a Federal Employee Program contract), partially offset by improvement within recently acquired drug stores, reduced net investment costs for expansion of in-store health clinics, increased sales of wider-margin generic drugs, higher sales of private label goods and improved retail store sales leverage.

After benefits from a reduction in the share count due to an active share repurchase program, we estimate that 2011 EPS will rise 4.5% to $2.81 from operating EPS of $2.69 in 2010 (excluding amortization of intangibles).

We expect top-line sales growth to slow in 2012, increasing only 5.4% to $114.3 billion, reflecting retail square footage growth of 2.5%, retail comparable store sales growth of 4.0%, and growth within the pharmacy benefit management segment of 4.0%.

However, we see margins expanding significantly in 2012, due to increased sales of generic drugs, a more profitable contribution from Aetna's contract, greater benefits from recent acquisitions, and as increasing PBM streamlining benefits offset implementation costs.

We look for the company to continue to put strong free cash flow generation to use by continuing to actively repurchase shares. Following a benefit from an approximate

2.5% reduction in shares outstanding, we expect EPS to rise 16% to $3.26 in 2012.

VALUATION We believe CVS is well positioned to benefit over the next few years as favorable demographics result in increased customer drug utilization and as a significant increase in generic drug offerings that we expect by 2012 leads to margin expansion. This is despite what we see as an unfavorable near-term environment characterized by a lull in new generic drug offerings, decreased consumer drug utilization in a weak economic environment, and rising drug reimbursement pressures.

Due to our expectation of a more favorable environment by the end of 2011, we believe the shares are currently undervalued on a P/E basis when compared to the S&P 500, CVS's historical range and its closest peers. Applying a multiple of 14.0X, a 3% discount to the forward P/E ratio of the S&P 500 (14.4X) versus a five-year median discount of 11%, and a slight premium to its five-year historical median P/E (13.5X) but a 15% discount to a weighted analysis of peers' P/Es (16.5X), to our 2012 EPS estimate of $3.26, we arrive at our 12-month target price of $46.

CORPORATE GOVERNANCE We believe that CVS's corporate governance practices are sound, and are above average for companies within the S&P 500 and the S&P Consumer Staples sector. Its board of directors is currently composed of 12 members, and is controlled by a supermajority of independent outsiders (independent outsiders comprise greater than 92% of the board, all except CEO and president Merlo). In addition, the full board is elected annually; no former CEO of the company serves on the board; the CEO serves on two or fewer boards of other companies; the performance of the board is regularly reviewed; a board-approved CEO succession plan is in place; outside directors meet without the CEO present; and the company does not have a poison pill in place.

However, shareholders do not have cumulative voting rights in director elections and the positions of chairman and CEO are combined.

INVESTMENT RISKS Risks to our recommendation and target price include a greater-than-anticipated reduction in prescription drug reimbursement levels, which would negatively impact margins; competition from discount retail operators intensifying faster that we expect, which may lead to an erosion of sales mostly from cash paying customers; and a weaker-than-expected macroeconomic environment, which could lead to reduced prescription volumes as consumers skip dosages or split pills and reduce purchases from the front end of stores. Also, PBM profitability may continue to deteriorate if the sales team is unable to clearly articulate the company's unique offerings to clients and how CVS can better manage health care outcomes.

CONCLUSION As an operator of both one of the largest retail drugstore chains and pharmacy benefit management businesses in the U.S., CVS Caremark is well positioned, in our view, to benefit from new management leadership and favorable industry trends. We see profitability accelerating as the U.S. population ages, generic drug sales rise and specialty pharmacy services demand increases. Additionally, we believe the company will experience significant benefits from health care reform as we think greater numbers of people who receive health care coverage are more likely to determine shopping destination based on convenience rather than price. With our target price indicating potential capital appreciation of 20% from current levels, our recommendation is Strong Buy.

S&P's views on stocks are constantly re-evaluated. Please refer to our most recent publication on this stock to see our current view.

Joseph Agnese

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