



# CVS Caremark

ANALYSIS *for* NYSE : CVS

APRIL 8, 2011

## PRESCRIPTION DRUGS SALES

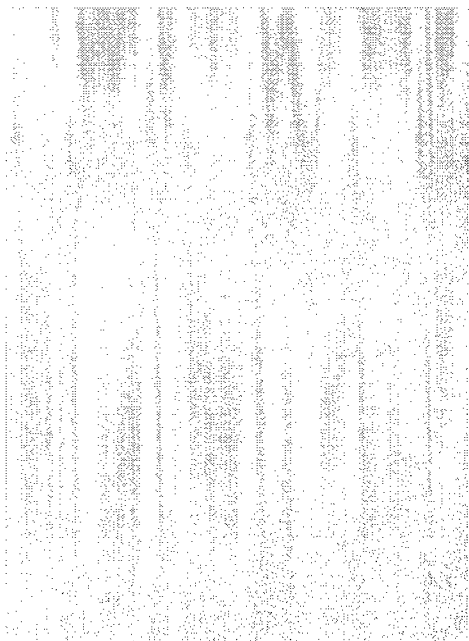
Revenue per Retail prescription <sup>4</sup>

CVS Caremark's Share of Retail  
prescriptions filled in US <sup>5</sup>

Retail prescriptions filled annually in  
US <sup>6</sup>



price estimate for CVS Caremark's stock  
 3. Pharmacy Benefit Management makes up less than 19% of the Trefis  
 price estimate for CVS Caremark's stock



	Divisions	% of Stock Price
<b>Price</b> <b>TREFIS</b> <b>\$39.55</b>	<b>Prescription Drugs Sales</b>	47.4%
	<b>OTC Drugs &amp; General Mercha...</b>	33.2%
	<b>Pharmacy Benefit Management</b>	19.4%
<b>Net Debt</b> \$23.34	<b>TOTAL</b>	100.0%

Our share price estimate and the overall company value is derived by summing-up the values of individual divisions/businesses in a sum-of-the-parts analysis. The value of each division is calculated using a discounted cash flow (DCF) methodology.

We forecast fundamental drivers like pricing, market share, and profit

were to decline to historical levels of close to 2.2% by the end of our forecast period.

**— SOURCES OF VALUE —**

Prescription drug sales are the biggest source of value for CVS Caremark, accounting for over half of its total value.

**i. Accessibility of stores and convenient shopping experience make CVS an attractive destination for consumers**

- CVS has a large network of strategically located retail drugstores across US. It has over 7000 pharmacy locations and around 75% of US population lives within three mile radius of CVS store, which is lower than any of the other drugstore chains in US (Walgreen claims to have 75% population within five mile radius). This makes CVS stores more accessible to a larger number of consumers than other pharmacies
- CVS employs over 26,000 pharmacists, nurse practitioners and physician assistants (more than Walgreen's number of 17000), who are responsible for interfacing with patients, advising customers and provide them more personalized attention as

- CVS has over 500 in-store MinuteClinics across 25 states make it a easy to get treatment for common ailments, obtain health screenings, or receive vaccinations. More than 70 percent of CVS stores are either open round-the-clock or offer extended hours, and over 60 percent have drive-thru windows, offering greater convenience to customers.

# Prescription Drugs Sales

The Prescription Drugs Sales division constitutes 47.4% of our \$39.55 price estimate for this stock, based on our sum of the parts analysis. The most important drivers for the Prescription Drugs Sales business are:

- Revenue per Retail prescription
- CVS Caremark's Share of Retail prescriptions filled in US
- Retail prescriptions filled annually in US

## — REVENUE PER RETAIL PRESCRIPTION —

Revenue per Retail prescription is CVS's cash receipt per prescription filled by its pharmacies. The receipt per prescription might be in the form of reimbursement from insurance providers, consumers or pharmacy business managers (PBM).

Longs Drug stores that were acquired in October 2008 are expected to increase Revenue per Retail prescription for CVS as their profitability increases. Following management discussion item from CVS Caremark 2009 annual report supports are view. "We have a solid track record at making the most of our acquisitions, roughly doubling the profitability of the drugstores we acquired from JCPenney in 2004 and from Albertsons in 2006." – CVS is expected to garner an increasing amount in prescription sales backed by customer focussed initiatives such as . ExtraCare loyalty program with over 64 million active cardholders, which is the largest among all US drugstore retailers. CVS pharmacy health savings pass, which lets customers obtain a 90-day prescription for any of more than 400 common generic maintenance medications at \$9.99 for a small \$10 annual fee.

Source for historical data and explanations can be found on the [Trafic.com website \(link\)](#)

several years, we opened 278 new or relocated stores in 2009, yielding approximately 2 percent retail square footage growth. We expect to open a similar number of locations each year for the foreseeable future. Our continued retail expansion in existing and new markets also enhances our ability to reach more PBM plan members with some of our newer offerings."

2. POISED FOR FASTER PRESCRIPTION GROWTH COMPARED TO PEERS BECAUSE OF EASIER ACCESSIBILITY – Increasing drug utilization, increasing health care spending and easier accessibility of stores will help increase CVS Caremark's Share of Retail prescriptions filled in US. These are discussed further below . Accessibility: CVS has a large network of strategically located retail drugstores across the US. About 75% of US population lives within three mile radius of CVS stores which is lower than any of the other drugstore chains in US (Walgreen claims to have 77% population

## Forecast Rationale

We considered the following factors in our forecast

1. **INCREASE IN PRESCRIPTION DRUG SALES** – We expect the market for US prescription drugs to grow at an annual 5.3% to reach \$350 billion in sales by 2015. Our expectation is in line with a report by Pembroke Consulting (quoted in sources section). Following factors will drive increasing expenditure on prescription drugs. Aging population will lead to increase in drug sales: US Census Bureau projects that within the next two decades, proportion of total population over 65 years will increase from 13 to 19% whereas that of between 20 years and 65 years of age will decline from 60% to 55%. Ageing population combined with the fact that older people contribute to a larger proportion of expenditure on drugs will lead to increase in prescription drugs market. Increasing government expenditure on healthcare to drive up drug sales: The 2010 US health reform legislation is expected to increase prescription drug sales, as over 30 million uninsured Americans will gain coverage and US government increases outlay on prescription drugs driven by an expansion of Medicaid and Medicare Part D plans.
2. **GROWTH IN REVENUE PER PRESCRIPTION TO LAG GROWTH IN OVERALL PRESCRIPTION SALES** – We expect average expense per prescription filled in US, to increase at 3.1% and reach about \$86 by 2015. Our growth expectation is in line with historical average growth over a period of six years from 2003 to 2009. Growth in revenue per prescription will lag growth in prescription drug sales because of the following reasons . Sales of lower priced generic drugs are expected to increase faster than that of branded drugs. This growth will be supported by the fact that patents for a large number of branded drugs, for example Pfizer’s Lipitor drug, will expire soon. Medicaid programs reimburse pharmacies based on the Average Wholesale Price (AWP) for branded drugs. First DataBank (FDB) and Medi-Span (MS) are the two principal companies calculating AWP as a markup of 20-25% over Wholesale Acquisition Price (WAC), which is obtained from drug manufacturers. Class action lawsuit settlements, which were approved in 2009, will lead to reduction in AWP’s and subsequently FDB, MS will cease publishing the AWP’s by September 2011. These changes to AWP would reduce Medicaid reimbursement to pharmacies by about 4 percent. This is expected to put downward pressures on revenue per prescription.

Sources for historical data and explanations can be found on the Trefis.com website ([link](#))

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
<b>Total Revenue</b> (Bil \$)	26.9	27.8	29.7	30.3	31.3	32.0	32.9	33.8	34.7	35.8	36.9
<b>Direct Expense</b> (Bil \$)	18.4	18.4	19.4	19.8	20.4	20.8	21.3	21.9	22.4	23.1	23.7
<b>Indirect Expense</b> (Bil \$)	9.53	7.81	8.91	8.49	8.98	9.21	9.55	9.88	10.2	10.6	10.8
<b>Gross Profit</b> (Bil \$)	8.51	9.37	10.3	10.5	10.9	11.2	11.5	11.9	12.3	12.7	13.2
<b>Free Cash Flow</b> (Bil \$)	N/A	N/A	N/A	N/A	1.94	1.99	1.99	2.05	2.11	2.17	2.37

In addition, you can see the detailed P&L for the Prescription Drugs Sales business in the Appendix ([link](#))

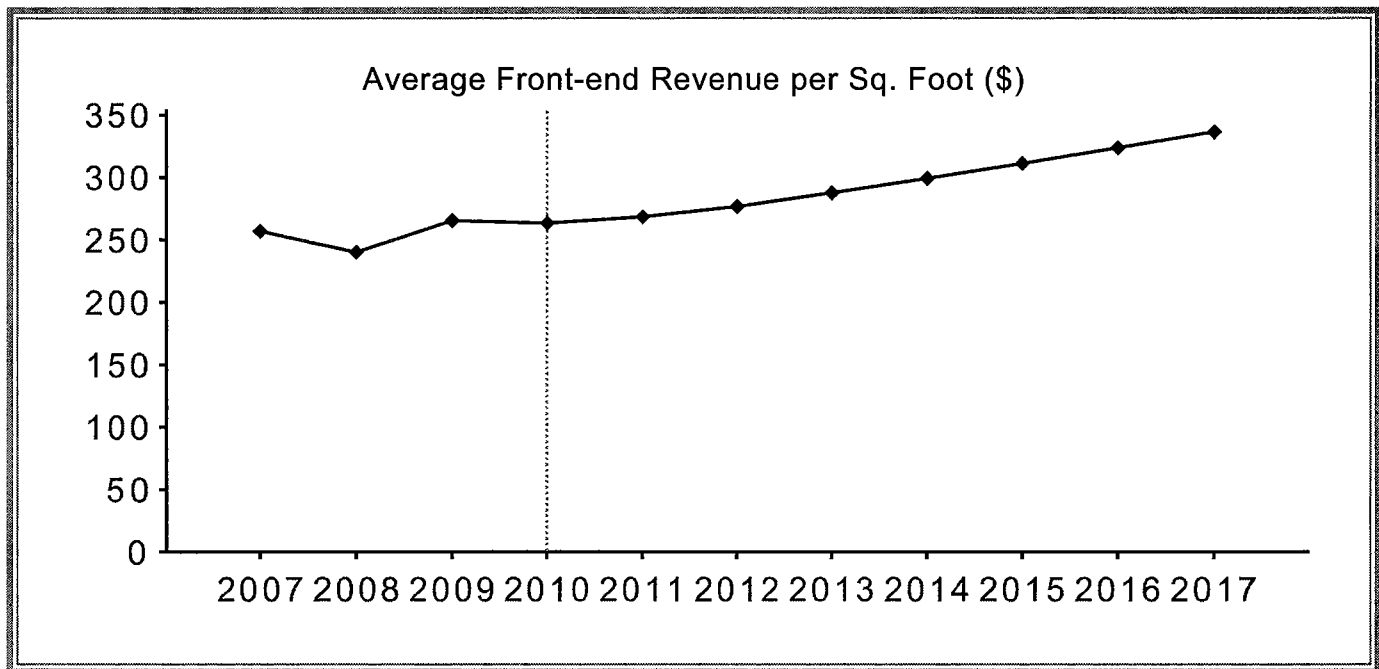
# OTC Drugs & General Merchandise Sales

The most important drivers for the OTC Drugs & General Merchandise Sales business are:

- Average Front-end Revenue per Sq. Foot
- Number of CVS Caremark Retail Drugstores in US
- Square Footage per Store

## — AVERAGE FRONT-END REVENUE PER SQ. FOOT —

This represents CVS Caremark's revenue from selling goods and merchandise other than prescription drugs, per square foot of CVS Caremark's overall sales area



Average Front-end Revenue per Sq. Foot decreased from \$258 in 2007 to \$239 in 2008. This decline was because of a high contribution of prescription drug sales as a result of Long Drug Store acquisition in 2008. Average Front-end Revenue per Sq. Foot increased to \$263 in 2009 driven by higher sale of private and CVS exclusive brands. We expect CVS Caremark's Average Front-end Revenue per Sq. Foot to grow at an annual average growth rate of 2% reaching \$308 by 2017, the end of our forecast period. This increase in average sales per sales area will be because of lower organic growth and increasing contribution from general merchandise sales as a result of reviving consumer demand in US.

### Forecast Rationale

We considered the following factors in our forecast.

- INCREASING POPULARITY OF PRIVATE LABEL GOODS** – As a large number of US households decided to cut spending during recession in 2009, they traded higher priced branded goods for private label goods which offered them reasonable quality at a lower price. Even as the economy recovers from recession, consumers are expected to stick with private label brands as they realise there is little difference between private label products and their branded



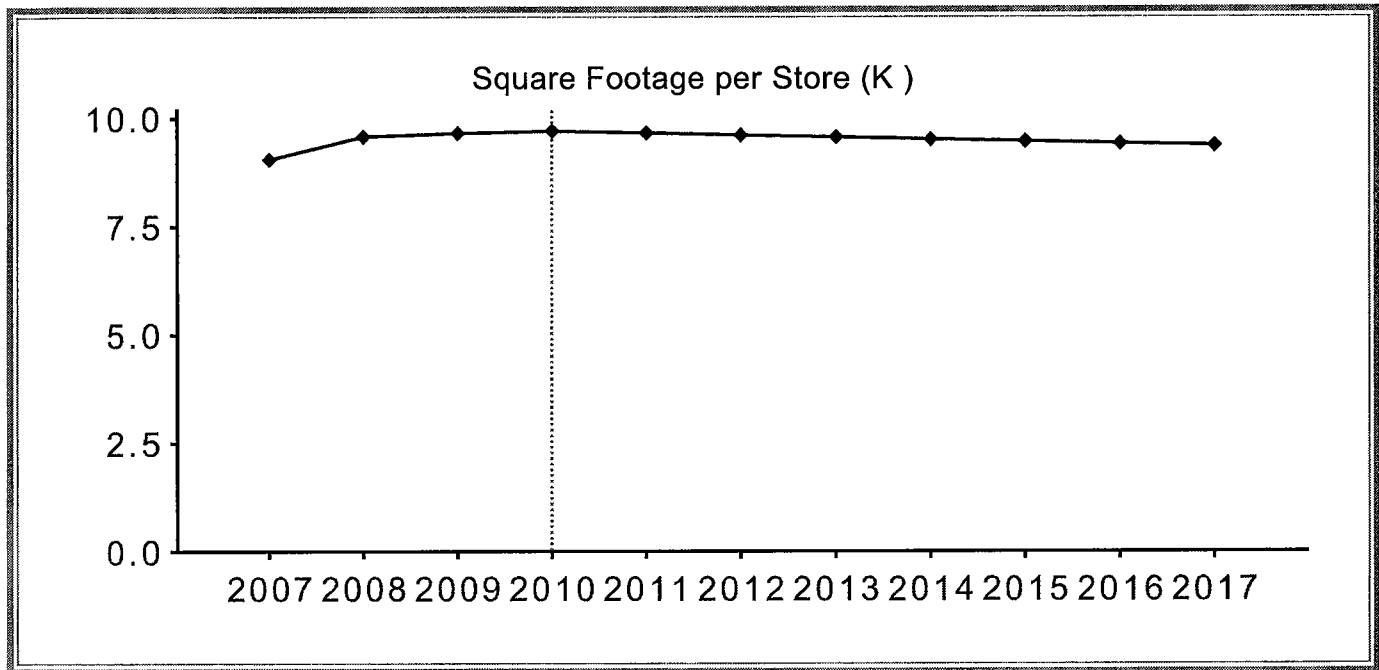
counterparts. Following management discussion item from CVS Caremark's annual report 2009 supports our view .  
"These products [private labels and CVS exclusive brands] accounted for close to 17 percent of front-store sales in 2009, but we believe that this figure can climb to as high as 20 to 25 percent."

2. CVS's CONVENIENT STORE LOCATIONS TO HELP INCREASE MARKET SHARE OF FRONT-END SALES – CVS has a large network of strategically located retail drugstores across US. About 75% of US population lives within three mile radius of CVS store, which is lower than any of the other drugstore chains in US (Walgreen claims to have 75% population

Sources for historical data and explanations can be found on the Trefis.com website ([link](#))

### — SQUARE FOOTAGE PER STORE —

It refers to the average retail space area per store measured in terms of square feet units



Square Footage per Store for CVS Caremark stores has increased by 7% from about 9000 in 2007 to 9500 in 2009 slightly. This can be attributed to addition of a large number of stores with a smaller average sales area. We expect Square Footage per Store for to grow very moderately by around 1% reaching \$10380 by 2017, till the end of Trefis forecast period.

#### *Forecast Rationale*

We considered the following factors for its forecast

- I. SLOWER GROWTH IN THE NUMBER OF RETAIL STORES TO WARRANT A MODERATE RISE IN SQUARE FOOTAGE – We expect the cumulative sales area for CVS retail stores to grow at a steady rate of 2% each year. However, Trefis expects number of stores to grow at a slower pace at 1%, thus leading to an estimated 1% annual increase in Square Footage per Store. The slower growth of CVS retail pharmacy stores is expected due to CVS's pharmacy network of over 64000 partnering pharmacies, made possible by the acquisition of Caremark Rx in 2007. Following management discussion item from CVS Caremark's 2009 annual report supports our view. "Consistent with the past several years, we opened 278 new or relocated stores in 2009, yielding approximately 2 percent retail square footage growth. We expect to open a similar number of locations each year for the foreseeable future."

Sources for historical data and explanations can be found on the Trefis.com website ([link](#))

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
<b>Total Revenue (Bil \$)</b>	14.5	15.0	18.0	18.4	19.2	20.2	21.2	22.4	23.7	25.0	26.4

# Pharmacy Benefit Management

The most important drivers for the Pharmacy Benefit Management business are:

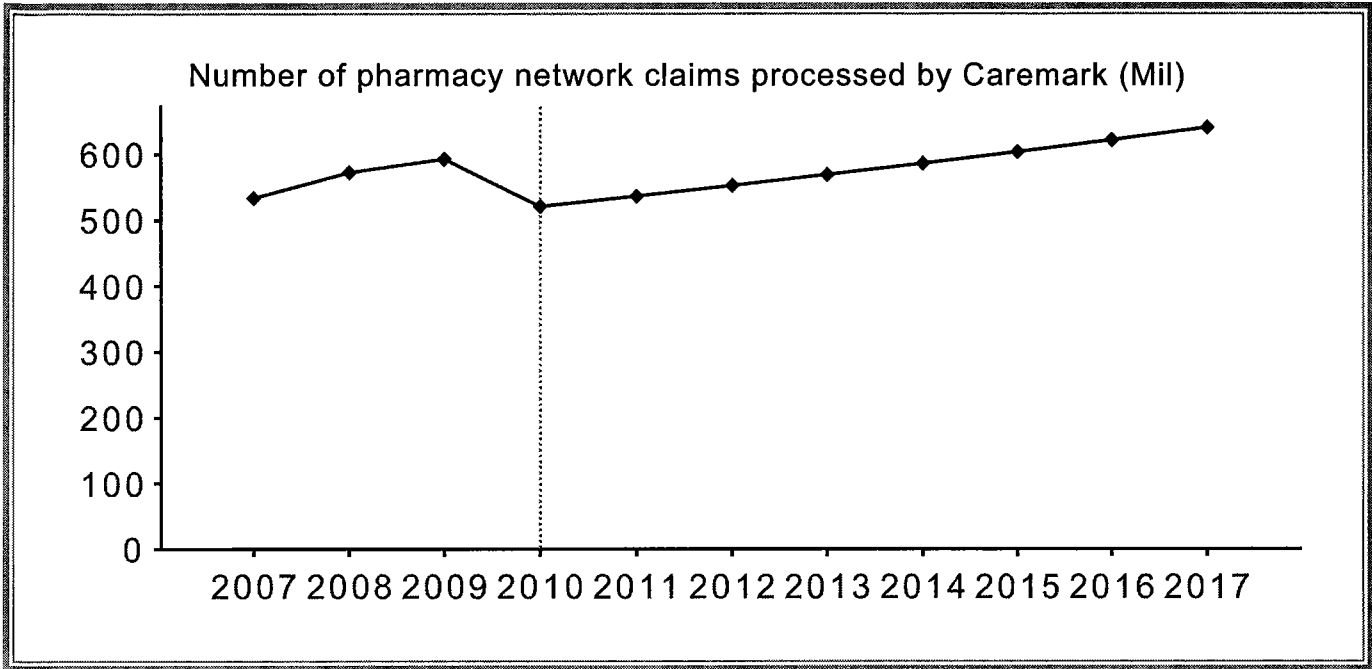
- Revenue per pharmacy network claims processed
- Number of pharmacy network claims processed by Caremark
- Revenue per Mail order pharmacy claim processed
- Number of Mail order pharmacy claims processed by Caremark

## — REVENUE PER PHARMACY NETWORK CLAIMS PROCESSED —

It refers to the average revenue per claim processed on one of the 64000 partnering pharmacies on CVS's pharmacy network, excluding the claims processed on CVS's own retail pharmacies.

The revenues from claims processed (prescriptions served) on the partnering pharmacies are included within Pharmacy Benefit Management services. The claims processed on CVS's own 7025 retail pharmacies are a part of its Retail Pharmacy business segment. Although, the prescriptions are settled at even the partnering pharmacies at CVS prices, there is profit sharing between CVS and the partnering pharmacy unlike the claims processed at CVS's own retail pharmacy where the entire profit margin accrues to CVS.

million people were enrolled in Medicare Part D. The Patient Protection and Affordable Care Act, signed into law on March 30'2010 by President Obama indirectly encourages drug utilization. The law is projected to expand insurance to 22 million Americans previously without coverage, made possible partly by an expansion of Medicaid



The Number of pharmacy network claims processed by Caremark increased from 423 million in 2007 to 592 million in 2009, which is primarily in line with the rise in the number of partnering pharmacies on the network. Going forward, we expect the Number of pharmacy network claims processed by Caremark to rise at around 2% year-on-year reaching 600 million in 2012 and eventually to 662 million by 2017, the end of our forecast period.

**Forecast Rationale**

We considered the following factors in our forecast.

Supporting

- I. EXPANSION OF HEALTH CARE COVERAGE TO MORE PEOPLE – In Jan 2006, Medicare Part D came into effect and expanded coverage to millions of people who were previously uninsured. With the result, as of June 2009, over 20 million

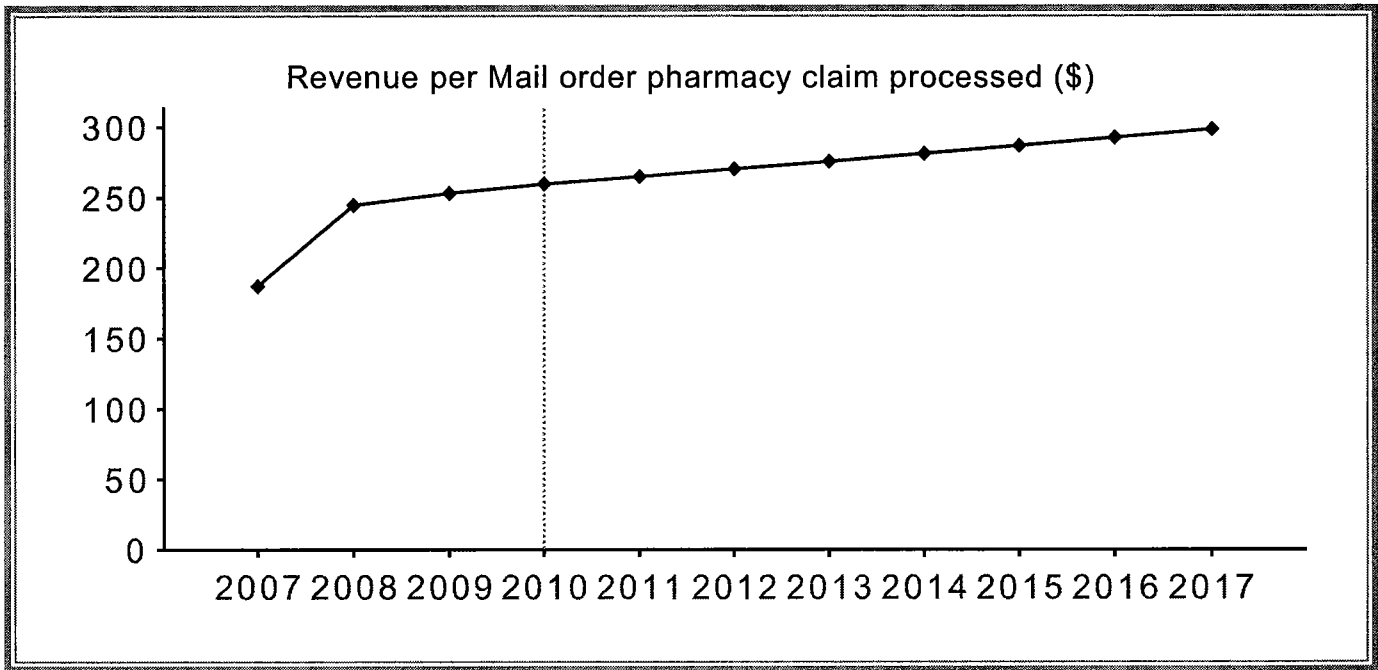
Caremark

2. IMPACT OF WALGREENS LEAVING CVS PHARMACY NETWORK – In June 2010, Walgreens announced exiting CVS Caremark pharmacy network, a program which allows consumers to buy prescription drugs from partnering pharmacies at the discounted CVS prices. Losing 7500 Walgreen's pharmacy stores is expected to have an adverse impact on Number of pharmacy network claims processed by Caremark

Sources for historical data and explanations can be found on the Trefis.com website ([link](#))

– REVENUE PER MAIL ORDER PHARMACY CLAIM PROCESSED –

It refers to the average revenue per claim processed at Pharmacy Services' mail facility, which involves serving prescriptions by delivery through mail.



The Revenue per Mail order pharmacy claim processed increased from \$227 in 2007 to \$253 in 2009. Going forward, we expect the Revenue per Mail order pharmacy claim processed to rise at around 4% year-on-year reaching \$265 in 2012 and eventually to \$319 by 2017, the end of our forecast period.

**Forecast Rationale**

We considered the following factors in our forecast.

Supporting

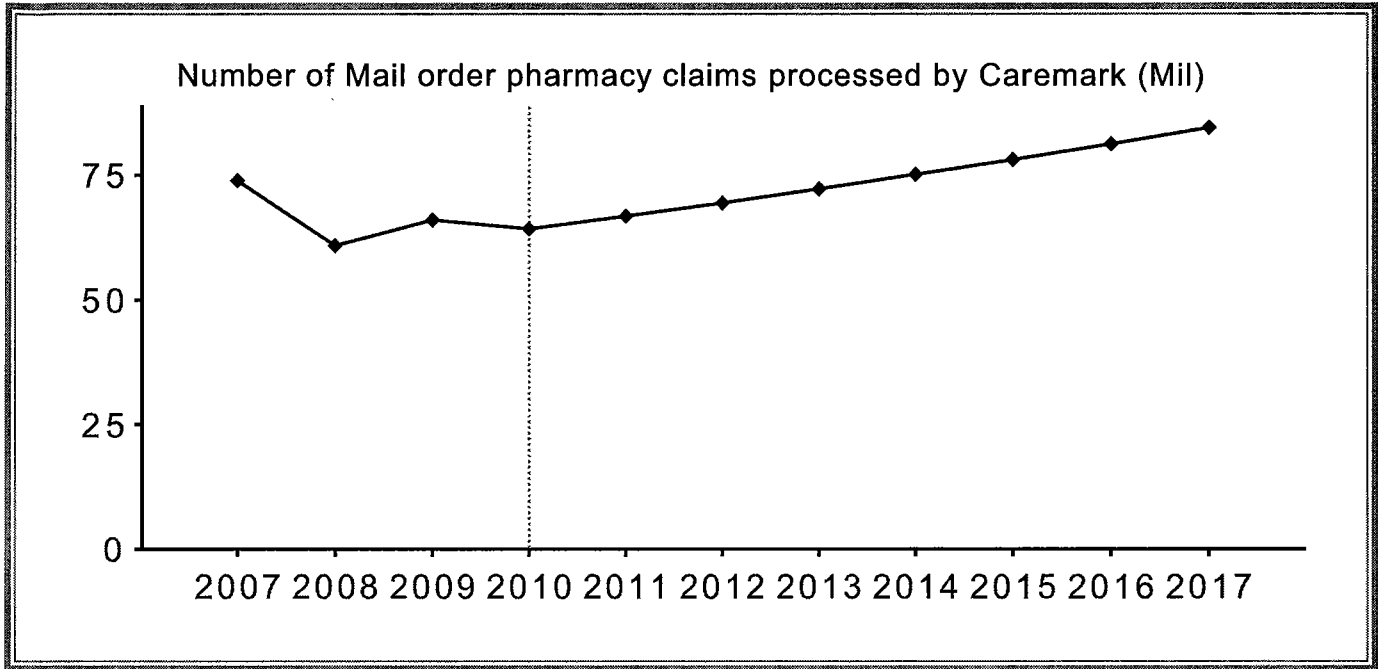
I. EXPANSION OF HEALTH CARE COVERAGE TO MORE PEOPLE – In Jan 2006, Medicare Part D came into effect and expanded coverage to millions of people who were previously uninsured. With the result, as of June 2010, over 29.3 million people were enrolled in Medicare Part D. The Patient Protection and Affordable Care Act, signed into law on March 30'2010 by President Obama indirectly encourages drug utilization. The law is projected to expand insurance to 32 million Americans previously without coverage, made possible partly by an expansion of Medicaid eligibility and partly through an insurance mandate. The newly insured patients are very likely to increase utilization of drugs. Expansion of coverage would have a lasting impact on rise in consumption of drugs.

2. AGING POPULATION AND IMPENDING RETIREMENT OF BABY BOOMERS – Baby Boomers (those born between 1945 and 64) are getting older and would need more medication in the years to come. Aging population of US, is expected to increase the per capita consumption of drugs.
3. DISCOUNTED PRICING FOR MAIL ORDER CLAIMS PROCESSING TO BOOST GROWTH IN REVENUE PER MAIL ORDER PHARMACY CLAIM PROCESSED – CVS offers claims processing by delivering prescriptions over mail at a much discounted price compared to sales at the retail pharmacy stores. Although, CVS loses out on the front-door sales of cosmetics and other personal care goods by mail facility, it stands to make higher margins on account of lower costs incurred on servicing the consumer. The discounted pricing is expected to favor a rise in Revenue per Mail order pharmacy claim processed in the future.

#### Mitigating

1. IMPACT OF THE PRODUCT MIX SHIFTING TOWARDS GENERICS – As more and more prescription drugs lose patent protection and become open to the low-cost generics, we expect the consumers to migrate to low cost substitutes. Though the generics have higher margins, they adversely impact the sales in dollar terms on account of their lower price. This will favor a decline in Revenue per Mail-order pharmacy claim processed going forward.





Mail choice claims processed increased from 61 million in 2008 to 66 million in 2009. This increase was primarily due to favorable net new business and significant adoption of mail choice plan design. During 2008, mail choice claims remained constant even though the CVS Caremark merger was completed. This was primarily due to the termination of the Federal Employees Health Benefit Plan (FEP) mail contract on December 31, 2007. We expect Number of Mail order pharmacy claims processed by Caremark to increase at about 4.6% annually reaching 80 million by the end of Traffic forecast period.

business and increasing adoption of Maintenance Choice program by clients. Mail choice penetration rate is calculated based on mail choice and specialty claims divided by total pharmacy claims processed. Before calculation all the prescriptions claims are adjusted to 30-day equivalent prescriptions. Since mail order prescriptions are mostly 90-day prescriptions, the adjusted mail choice prescriptions are higher than the absolute number of mail order prescriptions, almost 3x.

Sources for historical data and explanations can be found on the Trefis.com website ([link](#))

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
<b>Total Revenue</b> (Bil \$)	34.9	43.8	51.1	47.8	50.4	53.1	56.1	59.2	62.5	66.0	69.7
Other pharmacy services revenues (% of total)	0.78	0.86	0.69	0.89	0.89	0.89	0.90	0.92	0.93	0.93	0.94
Pharmacy network claims revenues (% of total)	59.6	65.1	66.6	64.2	64.0	63.8	63.6	63.4	63.3	63.1	62.9
Mail Order Pharmacy claims revenues (% of total)	39.6	34.1	32.7	34.9	35.1	35.3	35.5	35.7	35.8	36.0	36.1
<b>Direct Expense</b> (Bil \$)	31.9	40.2	47.2	44.4	46.8	49.3	52.0	54.8	57.8	60.9	64.1
<b>Indirect Expense</b> (Bil \$)	3.36	2.96	3.32	2.71	2.91	3.11	3.37	3.64	3.95	4.28	4.59
<b>Gross Profit</b> (Bil \$)	3.00	3.55	3.84	3.35	3.53	3.78	4.08	4.39	4.76	5.16	5.59
<b>Free Cash Flow</b> (Bil \$)	N/A	N/A	N/A	N/A	0.63	0.67	0.70	0.75	0.81	0.88	1.00

In addition, you can see the detailed P&L for the Pharmacy Benefit Management business in the Appendix ([link](#))

## Appendix

# Summary P&L for CVS Caremark

### Summary P&L for CVS Caremark

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
<b>Total Revenues</b> (Bil \$)	76.3	87.5	98.7	96.4	100	105	110	115	120	126	133
Prescription Drugs Sales (% of total)	35.2	31.8	30.1	31.4	31.0	30.4	29.8	29.3	28.7	28.2	27.7
OTC Drugs & General Merchandise Sales (% of total)	19.0	18.2	18.2	19.0	19.1	19.1	19.3	19.4	19.6	19.7	19.8
Pharmacy Benefit Management (% of total)	45.8	50.0	51.7	49.6	49.9	50.4	50.9	51.3	51.7	52.1	52.4
<b>Direct Expenses</b> (Bil \$)	60.2	69.2	78.3	76.2	79.7	83.2	87.1	91.2	95.5	100	104
Prescription Drugs Sales (% of total)	52.8	51.2	50.5	52.0	51.6	50.8	50.0	49.2	48.3	47.5	46.8
OTC Drugs & General											



# Detailed P&L for the Prescription Drugs Sales Business

The most important drivers for the Prescription Drugs Sales business are discussed above, here is the detailed P&L.

## Prescription Drugs Sales: Detailed P&L

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
<b>Revenues</b>											
Prescription Drug Revenues (Bil \$)	26.9	27.8	29.7	30.3	31.3	32.0	32.9	33.8	34.7	35.8	36.9
Revenue per Retail prescription (\$)	50.9	49.7	48.1	47.6	47.1	46.6	46.2	45.8	45.5	45.3	45.0
Retail prescriptions filled annually in US (Bil)	3.52	3.54	3.59	3.62	3.69	3.76	3.84	3.93	4.02	4.11	4.20
CVS Caremark's Share of Retail prescriptions filled in US (%)	15.0	15.8	17.2	17.6	18.0	18.3	18.5	18.8	19.0	19.3	19.5
<i>Total Revenues</i> (Bil \$)	26.9	27.8	29.7	30.3	31.3	32.0	32.9	33.8	34.7	35.8	36.9
<b>Expenses</b>											
Direct Expenses (Bil \$)	18.4	18.4	19.4	19.8	20.4	20.8	21.3	21.9	22.4	23.1	23.7
Gross Profit Margin for Prescription drug sales (%)	31.7	33.7	34.7	34.8	34.9	35.0	35.1	35.3	35.4	35.6	35.7
Indirect Expenses (Bil \$)	9.53	7.81	8.91	8.49	8.98	9.21	9.55	9.88	10.2	10.6	10.8
Net Other Operating Assets as a % of Revenues (%)	40.4	32.7	28.1	28.4	28.4	28.4	28.4	28.4	28.4	28.4	28.4
Operating Working Capital as % of Gross Profit (%)	25.5	27.0	29.7	30.1	29.5	29.0	28.7	28.4	28.1	27.8	27.5
CapEx as a % of Revenues (%)	10.5	11.8	12.4	9.90	9.93	9.95	9.98	9.99	10.00	10.0	10.0
Effective Tax Rate (%)	35.1	35.8	33.5	34.5	34.5	34.5	34.5	34.5	34.5	34.5	34.5
Corporate Expenses as % of Gross Profit (%)	2.55	2.52	2.64	3.09	3.05	3.00	2.90	2.85	2.80	2.78	2.75
SG&A Expenses as % Gross Profit (%)	57.5	54.3	55.5	55.6	55.7	55.7	55.8	55.9	55.9	56.0	56.0
<i>Total Expenses</i> (Bil \$)	27.9	26.2	28.3	28.3	29.3	30.0	30.9	31.7	32.6	33.6	34.5
<b>Gross Profits</b> (Bil \$)	8.51	9.37	10.3	10.5	10.9	11.2	11.5	11.9	12.3	12.7	13.2
<b>Free Cash Flow</b> (Bil \$)	N/A	N/A	N/A	N/A	1.94	1.99	1.99	2.05	2.11	2.17	2.37



# Detailed P&L for the OTC Drugs & General Merchandise Sales Business

The most important drivers for the OTC Drugs & General Merchandise Sales business are discussed above, here is the detailed P&L.

## OTC Drugs & General Merchandise Sales: Detailed P&L

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
<b>Revenues</b>											
Front-end Revenues (Bil \$)	14.5	15.9	18.0	18.4	19.2	20.2	21.3	22.4	23.7	25.0	26.4







**Pharmacy Benefit Management: Detailed P&L continued**

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
<b>Free Cash Flow</b> (Bil \$)	N/A	N/A	N/A	N/A	0.63	0.67	0.70	0.75	0.81	0.88	1.00