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North America Equity Research
05 April 2018

J.P.Morgan

AmerisourceBergen

ABC Week Day 4: Specialty Distribution

Neutral

ABC, ABC US

Price: $86.25

Price Target: $105.00

Healthcare Technology & Distribution

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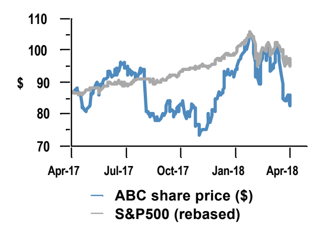
Price Performance



	YTD	1m	3m	12m
Abs	-6.1%	-8.2%	-8.4%	-0.8%
Rel	-5.0%	-6.5%	-5.5%	-12.9%

Given the increasing importance of specialty across the Rx channel, for Day 4 of ABC week, we take a deeper dive into ABC's Specialty Distribution business, which we view as a key differentiator. ABC has a leading position in oncology, reaching more than half of all community-based oncologists in the U.S., and is also a leading distributor in the dialysis, blood plasma product and vaccine markets. Recall that we hosted a conference call on Monday afternoon with CEO Steve Collis and CFO Tim Guttman. See our note here for key takeaways from the call.

- **Specialty should continue to provide a solid growth opportunity.** According to data from IQVIA, specialty drug sales were $196B in 2017 on an invoice price basis, up ~9% y/y, and compared to ~1% y/y growth for the overall pharma market. Specialty drugs accounted for ~43% of total pharma sales in 2017, up from 35% in 2014, with industry sources projecting it to reach 55% in 2021, driven by a robust pipeline of specialty drugs and strong sales ramps for newly launched products
- **ABC is the largest specialty pharmaceutical distributor based on revenue.** AmerisourceBergen Specialty Group (ABSG) revenues were $31.5B in FY17, or ~19% of total revenue before intrasegment eliminations, and up ~10% y/y. While ABC does not provide disclosure on ABSG margins, the company has indicated in the past that specialty margins are above core drug distribution. We estimate ABSG accounted for ~23% of total adjusted operating profit.
- **We expect continued strong growth for the legacy ABSG businesses going forward.** As of the end of FY17, ABSG had delivered 15 consecutive quarters of growth in excess of 10%. While ABC will no longer break out disclosure on ABSG going forward due to a reorganization of the operating structure effective 9/30/17, we would expect revenue to continue to grow in the double digit rate going forward.
- **Margin expansion opportunity from specialty generics and biosimilars.** In the past, ABC had seen strong contribution from certain specialty generic launches, although we have seen fewer material launches more recently. Biosimilars represent a potential profit driver, depending on whether products fall under the medical benefit or whether discounting is done up front or via rebates on the back end.
- **Potential reimbursement changes for Part B drugs could drive a headwind for specialty distributors.** While not directly reimbursed under Part B, distributors could see a volume/margin headwind if lower reimbursement causes physicians to shift patients to the hospital setting or sell their practices to hospital groups.

AmerisourceBergen (ABC;ABC US)

FYE Sep	2015A	2016A	2017A	2018E	2019E
EPS ($)					
Q1 (Dec)	1.14	1.27	1.36	1.55A	-
Q2 (Mar)	1.45	1.68	1.77	1.75	-
Q3 (Jun)	1.20	1.37	1.43	1.60	-
Q4 (Sep)	1.17	1.30	1.33	1.65	-
FY	4.96	5.62	5.88	6.55	7.34
Bloomberg EPS FY ($)	4.97	5.55	5.88	6.55	7.36

Source: Company data, Bloomberg, J.P. Morgan estimates. 'Bloomberg' above denotes Bloomberg consensus estimates.

Company Data	
Price ($)	86.25
Date Of Price	04-Apr-18
52-week Range ($)	106.27-71.90
Market Cap ($ mn)	19,045.90
Fiscal Year End	Sep
Shares O/S (mn)	221
Price Target ($)	105.00
Price Target End Date	31-Dec-18

See page 13 for analyst certification and important disclosures.

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Specialty Distribution

Background

AmerisourceBergen has long had a presence in specialty distribution. Bergen Brunswig (which merged with AmeriSource in 2001) was making acquisitions in the space as early as 1997, when it acquired Besse Medical, and in 1998, when it acquired Lash Group. Since then, AmerisourceBergen has continued to acquire multiple specialty businesses including U.S. Bioservices in 2002, Xcenda in 2007 and Innomar Strategies in 2009. While companies such as World Courier, Theracom, Premier Source and Innomar Strategies have elements that fall within specialty, those companies have actually been included in the ABC's Other segment for reporting purposes. Finally, as part of the 2014 investment in a 19.9% stake in Brazilian drug distributor Profarma, the two companies formed a joint venture for specialty distribution and services (ABC owns a 50% stake in the specialty JV).

Table 1: ABC Selected Specialty/Consulting Acquisitions (2003-2018)

Fiscal Year	Date	Target company	Target's business	Price paid ($M)
F2017	Feb-17	Watson Health Management	Reimbursement consulting in Canada	N/A
F2014	Mar-14	Profarma (minority int.)	Brazilian drug distribution/specialty JV	$100.0
F2012	Mar-12	World Courier Group	Clinical trial logistics	$520.0
F2012	Nov-11	Theracom (CVS)	Specialty consulting and distribution	$250.0
F2011	Sep-11	IntrinsiQ LLC	Info systems for oncology	<$45.0
F2011	Sep-11	PremierSource	Consulting services to manufacturers	<$45.0
F2009	Jun-09	Innomar Strategies	Specialty services in Canada	$13.8
F2007	Apr-07	Xcenda LLC	Consulting services	$25.2
F2007	Nov-06	Access MD Inc.	Canadian specialty pharmacy	$12.9
F2007	Oct-06	IgG of America, Inc.	Specialty Pharmacy (IVIG)	$37.2
F2006	Feb-06	Network for Medical Communication	Oncology/Specialty provider	$86.6
F2003	Jan-03	US Bioservices Corp	Specialty Pharmacy	$143.0

Source: Company reports, J.P. Morgan estimates

According to IQVIA, the market for specialty pharmaceuticals in the U.S. was $196 billion in 2017. Importantly, the specialty market has been growing at higher rates versus the core pharmaceutical market. However, we estimate that a significant portion of that specialty pharmaceutical market flows through the specialty pharmacy and retail pharmacy channels. Specialty distributors primarily focus on drugs that are distributed to physician offices, clinics and institutions, which represents a smaller subset of the overall specialty pharmaceutical market.

Competitive Landscape

Similar to traditional drug distribution, specialty distribution is also heavily consolidated. AmerisourceBergen has a leading position in oncology products, reaching more than half of all community-based oncologists in the U.S., and is also a leading distributor in the dialysis, blood plasma product and vaccine markets. We estimate that McKesson is the second largest specialty distributor, and has a significant presence through its US Oncology business. Cardinal Health has a smaller presence in specialty distribution relative to its two peers, although the company’s footprint has increased following the acquisition of Metro Medical in 2015. Another sizeable player outside of the big three wholesalers is CuraScript SD, which is owned by Express Scripts.

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Table 2: Specialty Distributor Revenue (FY17)

$ in billions

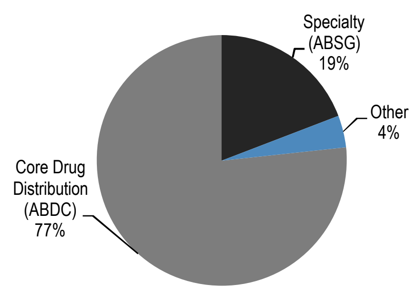
	FY17 Revenue
AmerisourceBergen Specialty Group (ABSG)	$32
McKesson Specialty Health	$24
Cardinal Health Specialty Solutions	$12
CuraScript SD (Express Scripts)	$4

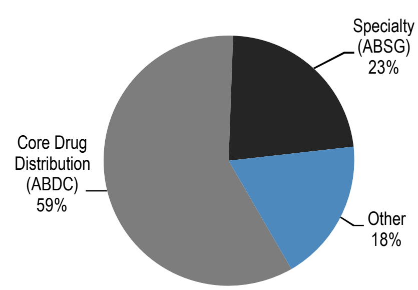
Source: Company reports, J.P. Morgan estimates. Note: revenues shown also include additional services to physicians and manufacturers beyond specialty distribution.

Financial Performance

In F2017 we estimate that legacy ABSG accounted for ~19% of the company's total revenues (Figure 1), and given the margin profile of the business, we estimate it accounted for ~23% of adjusted operating profit. Of note, effective September 30, 2017, ABC reorganized their operating structure resulting in the combination of the legacy AmerisourceBergen Drug Corporation (ABDC) and AmerisourceBergen Specialty Group (ABSG) into a single operating segment (Pharmaceutical Distribution Services), and will no longer break out details around the ABSG segment.

Figure 1: ABC Revenues (left) and Adjusted Operating Profit (right) by Segment (F2017E)

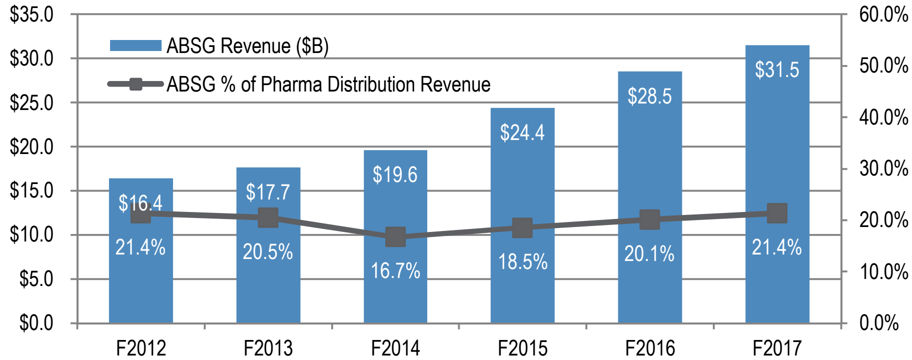




Source: Company reports and J.P. Morgan estimates.

Specialty distribution has been a faster growing market for the pharmaceutical distributors, representing an important channel of growth. In F2017, ABSG revenues were up 92% versus F2012 levels. We estimate ABSG revenues would have still been up in excess of 78% excluding the impact of manufacturer shifts of certain infused oncology products from full line distribution to specialty distribution. Legacy ABSG represented ~21% of Pharmaceutical Distribution revenue before intrasegment eliminations in F2017 (or ~19% excluding the aforementioned impact of manufacturer shifts), which compares to the ~21% it represented in F2012, although we note that this is mainly the result of the addition of the Walgreens business in late 2013, as growth in ABSG has been solid over the past few years (16 consecutive quarters of double digit growth).

Figure 2: ABSG Revenue and % of Total Pharmaceutical Distribution Revenue
$ in billions



Source: Company reports. Note: before intrasegment eliminations.

While the company has not provided any color recently, in the past management had provided guidance for operating margins 50-55 bps higher in specialty vs. traditional drug distribution (this guidance was provided with the company's initial F2014 outlook). While specialty margins tend to be higher than the overall distribution average, margins have been pressured somewhat over the past few years as lower-margin segments of the business have been growing faster. Further, we note that declining reimbursement rates for Medicare Part B drugs had caused some headwind on the top line, as some community oncologists have moved from private practice to hospital settings as a result of this reimbursement pressure. In those cases, drugs may subsequently be purchased under hospital prime vendor relationships rather than through specialty distributors such as ABSG. This had a negative impact in 2013 following sequestration-related reimbursement cuts, and could potentially drive some incremental headwind going forward should there be any changes to Medicare Part B reimbursement for oncology drugs.

Potential Opportunities/Risks

Specialty Drugs Should Continue to Provide a Growth Opportunity

Strong top-line growth characteristics for specialty drugs provide an attractive opportunity across the pharmaceutical supply channel. According to data from IQVIA, specialty drug sales increased to $196 billion in 2017 on an invoice price basis, which was up ~9% versus the prior year, and compared to the overall market, which was up ~1% y/y. Specialty drugs accounted for roughly 43% of total pharmaceutical sales in 2017, up from 35% in 2014. Estimates from various Rx channel participants project that specialty drugs will represent 55% of total drug spend in 2021.

Table 3: U.S. Specialty and Overall Market Growth Rates (2014-2017)
$ in billions

	2014	2015	2016	2017
Traditional (Non-Specialty)	$245	$263	$265	$254
Y/Y chg		*7%*	*1%*	*-4%*
Specialty	$133	$162	$179	$195
Y/Y chg		*22%*	*10%*	*9%*
Total	$378	$425	$444	$449
Y/Y chg		*12%*	*4%*	*1%*
Specialty % of Total	35%	38%	40%	43%

Source: IQVIA.

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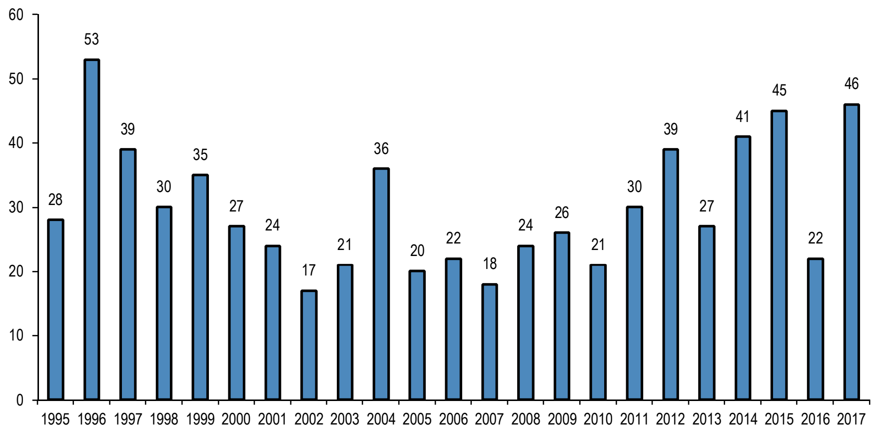
New Drug Development

There were 46 new molecular entities (NMEs) approved by the FDA in 2017, which is up sharply y/y, and represents one of the highest years for new approvals since 1996. This is up nicely vs. 2016, which was one of the lowest years since 2010 and follows stronger years in 2015, with 45 NMEs approved by the FDA, and 2014, with 41 NMEs approved (see Figure 2 below). We estimate over half of the NME approvals in 2017 were specialty drugs, continuing a recent trend that we had seen in prior years. Given the robust pipeline of biotech and specialty drugs, we expect to see strong numbers of specialty drug approvals going forward (note that as of late March 2018, the FDA had already approved 6 NMEs this year).

Figure 3: FDA New Molecular Entity Approvals (1995 - 2017)

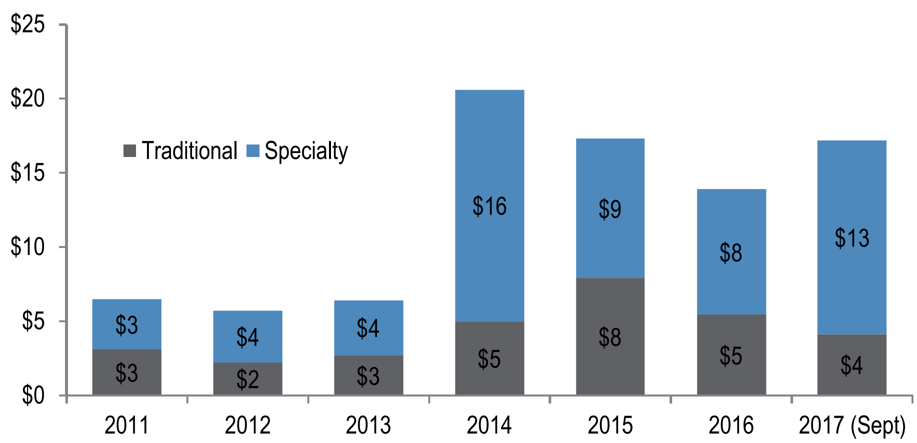


Source: FDA.

Specialty drugs have accounted for a significant portion of spending on new brand drugs that have come to market in recent years. Based on the latest data available, spending on new specialty brands accounted for 76% of total spending on new branded drugs in the U.S. for the 12 months ended September 2017, which is up from 61% of total spending on new branded drugs in the U.S. in 2016 and 52% in 2011 and compared to an average of 63% over the 2011-2017 period.

Figure 4: U.S. New Brand Spending Dollars (2011-2017)

$ in billions



Source: IQVIA.

Specialty Generics

Given ABC's sizeable business in specialty distribution, we note that the opportunity around specialty generics could represent a potential tailwind going forward. Throughout F2009-F2011 ABC experienced above-average earnings contribution from three key specialty generic oncologics: oxaliplatin (generic for Eloxatin, which had ~$1.5B in sales), gemcitabine (generic for Gemzar, which had ~$0.8B in sales) and docetaxel (generic for Taxotere, which had ~$1.2B in sales). In Table 4, below, we detail the combined annual EPS contribution from these three generic oncology drugs over that period. Generics for both Gemzar and Taxotere did not launch until F2011; therefore, the EPS contribution in F2009/F2010 was solely from oxaliplatin. In F2011, oxaliplatin contributed ~$0.24, and we estimate gemcitabine and taxotere contributed $0.10 and $0.14, respectively.

Table 4: Contribution from Specialty Oncologics, F2009-F2011

	F2009	F2010	F2011
Specialty Generics EPS Contribution	**$0.05**	**$0.25**	**$0.48**
% of Total EPS	*3.0%*	*11.6%*	*18.8%*
Total Company EPS	**$1.73**	**$2.16**	**$2.54**
% Change Yr/Yr	*19.6%*	*25.3%*	*17.5%*

Source: Company reports and J.P. Morgan estimates.

Since F2011 there has not been any single year where generic specialty drug launches have as significant of an impact as the three drugs discussed above. Recall that ABC had previously indicated on the F1Q16 earnings call that a delay in the launch of a generic version of Aloxi was one factor that caused the company to lower the FY16 adjusted EPS guidance. However, we note that in late March, Teva and Dr. Reddy's launched generic versions of Aloxi, with Cipla launching an authorized generic. That said, despite the company's commentary that the contribution from new generic launches is expected to be similar to the prior year in F2018, we believe that future launches of generics for physician administered drugs could potentially be a positive contributor to earnings for ABC over the longer term.

Biosimilars

Biosimilars could potentially provide an incremental benefit for the Rx channel over time. As shown in Table 5 below, there are currently three biosimilars that have been approved under the 351(k) BLA pathway and are currently on the market: Zarxio, Inflectra and Renflexis. There have also been six other biosimilar approvals (Erelzi, Amjevita, Cyltezo, Mvasi, Ogivri and Ixifi), although none of those have launched due to several reasons, including ongoing litigation and settlement. In addition to additional biosimilar versions of Remicade, Humira and Enbrel, the near term pipeline also includes additional potential biosimilar versions of Amgen's Neupogen/Neulasta, as well as Genentech's Herceptin and Rituxan which are in late stage development.

Table 5: Biosimilar Approvals in the U.S.

Approval Date	Biosimilar	Biosimilar Manufacturer	Non-Proprietary Name	Innovator Drug	Innovator Manufacturer	Status
3/6/2015	Zarxio	Sandoz (Novartis)	filgrastim-sndz	Neupogen	Amgen	Launched on 9/3/2015
4/5/2016	Inflectra	Celltrion/Pfizer	infliximab-dyyb	Remicade	J&J	Launched on 11/21/2016
8/30/2016	Erelzi	Sandoz (Novartis)	etanercept-szzs	Enbrel	Amgen	Not yet launched
9/23/2016	Amjevita	Amgen	adalimumab-atto	Humira	AbbVie	No launch until 1/2023 per settlement
4/24/2017	Renflexis	Samsung Bioepis/Merck	infliximab-abda	Remicade	J&J	Launched on 7/24/2017
8/25/2017	Cyltezo	Boehringer Ingelheim	adalimumab-adbm	Humira	AbbVie	Not yet launched
9/14/2017	Mvasi	Amgen/Allergan	bevacizumab-awwb	Avastin	Genentech (Roche)	Not yet launched
12/1/2017	Ogivri	Mylan	trastuzumab-dkst	Herceptin	Genentech (Roche)	Confidential settlement with Roche
12/13/2017	Ixifi	Pfizer	infliximab-qbtx	Remicade	J&J	No plans to launch

Source: FDA.

Several of the drugs that are approved or are in the near term pipeline are administered in physician offices, and could therefore flow through the specialty distribution channel. That said, in terms of the competitive dynamics, we believe that biosimilars are more likely to resemble incremental branded competitors. Therefore, if discounting on these products is done on the back end via rebates (versus on the front end as with traditional generics), the distributors may not realize a significant step up in profits on the biosimilar. Note that ABC has previously indicated that uncertainties on the legal and regulatory side have caused it to take a conservative view on the near term impact from biosimilars (the company has indicated that it expects no significant contributions from biosimilars in F2018).

Potential Regulatory Changes around Drugs Reimbursed Under Part B

The President's budget that was released in February, included a proposal to modify reimbursement of Part B drugs. By way of background, Medicare currently reimburses providers under Part B for certain physician-administered drugs based on a formula of Average Sales Price (ASP) plus 6%. As of April 1, 2013 due to sequestration, Medicare payments to providers were reduced by 2%, which made the effective reimbursement ASP+4.3% (the reduction only applied to the government's portion of the payment and not the patient’s 20% cost share). The proposal would lower payment from 106% of ASP to 103% of ASP. It is important to note that the President's budget proposal is not binding and does not lead to any direct changes, but rather serves as a blueprint for potential future legislative action. We note that there have been other attempts in the past to change the reimbursement model for drugs that are reimbursed under Medicare Part B with an aim to change prescribing incentives and improve quality, value and access, including a demonstration project that was introduced nearly 2 years ago that would have shifted to a lower ASP markup and added a flat fee, although that demonstration was subsequently shelved after significant pushback from various stakeholders.

In the past, there have also been discussions around shifting reimbursement for drugs reimbursed under Part B to Part D, as a way to move away from the current “buy and bill” model. There has been a criticism in the past that the ASP model incentivizes physicians to administer the highest cost drugs given a higher dollar value of the ASP markup. By shifting reimbursement to Part D, providers would instead get paid solely for the administration of the drug. This could also open opportunities under the pharmacy benefit to apply PBM tools such as utilization management tools and formularies, and create potential competition among manufacturers. However, providers argue that the profit they make on the ASP markup not only covers the administration of the drug but also supports the rest of the practice. As a way to move away from the buy and bill model, some commercial payors have shifted reimbursement to the pharmacy benefit and moved to new models, including “white bagging” (where the specialty drug is shipped directly to provider who will administer it to the patient) and “brown bagging” (where the product is shipped to patient who brings it themselves to the provider who will administer the drug). Under these models, product could leave the specialty distribution channel (if the specialty pharmacy sources direct from manufacturers), or remain in the wholesale channel if specialty pharmacies source through wholesalers (although likely at a lower margin).

As it relates to how these potential changes could impact companies that distribute specialty drugs reimbursed under Medicare Part D, we note that specialty distributors do not have direct exposure to reimbursement changes, as physicians procure the drugs from specialty distributors and are reimbursed under the Medicare Part B program for administering these drugs (i.e., the “buy and bill” model). Specialty distributors could potentially be impacted by lower volumes as a result of reimbursement pressure although there are potential offsets. If providers continue to be squeezed on reimbursement due to changes on Medicare Part B reimbursement, there is potential for an indirect headwind to the specialty distributor for two reasons: 1) physicians could potentially shift patients to the hospital setting if reimbursement moves too low; and 2) physicians, such as community-based oncologists, could sell their practices to hospital groups. We note that there could be potential offsets, including: 1) expanding services to those physicians that are exposed to reimbursement pressure to help physicians better manage through the impact of reimbursement cuts; and 2) recapturing volume through existing hospital relationships that may see their pharmacy business grow as a result of reimbursement pressure on community-based practices (although this may be at a lower margin).

In terms of framing the potential financial impact, according to CMS, spending on drugs reimbursed under Medicare Part B was \$24.6B in 2015. If we apply a 10% CAGR to that amount, that would lead to ~\$36B in spending on specialty drugs reimbursed under Medicare Part B in 2019. Given its strong oncology business, we estimate that ABC has ~45% share, making it larger than the peers on an absolute basis, and also, given a less diversified business, we believe specialty distribution represents a greater percent of total profit dollars at ABC relative to peers. If we assume gross margins for the specialty distribution business are currently in the 2.5% range, and take a hypothetical 10-20% reduction in profit as a result of the potential changes discussed above, that could equate to a 1.9%-3.9% headwind to our CY19 adjusted EPS estimate for ABC.

Specialty Group Services

Within ABC’s legacy Specialty Group (ABSG) there are various divisions that provide not only pharmaceutical distribution, but also services to manufacturers and other players within the specialty chain. Legacy ABSG consisted of several smaller companies that focus on physicians, manufacturers or patients. Listed below are the various companies within legacy ABSG that provide products and services throughout the specialty spectrum.

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Table 6: ABSG Portfolio of Companies

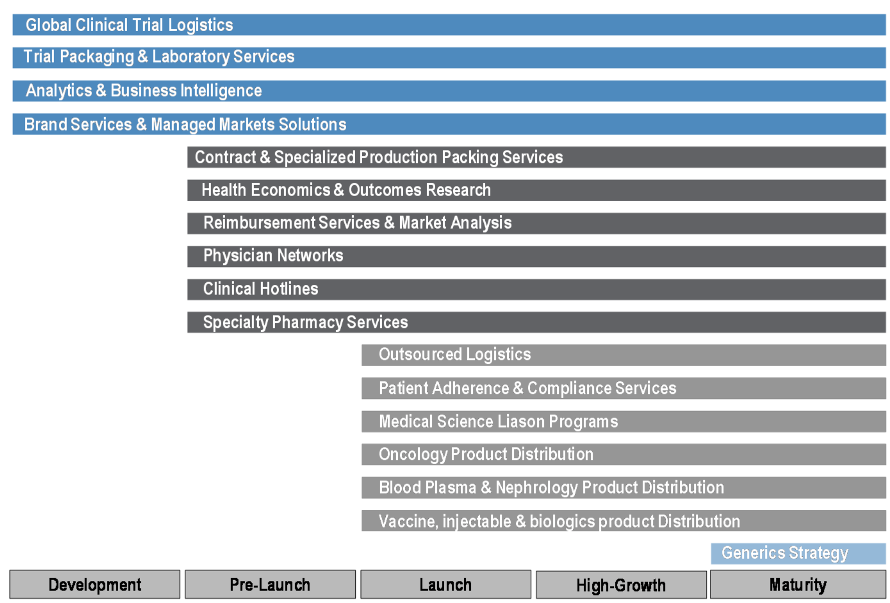
Segment/Company	Customer	Focus
Provider Solutions		
Oncology Supply	Physicians	Distributor of chemotherapy, supportive oncology products and practice management solutions
Besse Medical	Physicians	Distributor of specialty injectables, vaccines, biologics and diagnostics to specialty physicians
ION	Physicians	Physician services network (membership represents >55% of community oncologists in U.S.)
IPN	Physicians	Physician services network serving various specialties outside of oncology
IntrinsiQ	Hospitals, physicians, manufacturers	Software for managing chemotherapy treatments and workflow
US Bioservices	Manufacturers, physicians	Nationwide specialty pharmacy and nursing services
ASD Healthcare		
ASD	Hospitals, alternate site, pharmacies	Distributor of blood plasma products, nephrology products, flu vaccine, and specialty drugs
Global Specialty Logistics		
ICS	Manufacturers	Outsourcing partner for logistics, clinical services and title distribution
World Courier*	Manufacturers	Specialty logistics for global clinical trials
ABCS*		
Xcenda	Manufacturers	Commercialization consulting services, including brand strategy, messaging and market research
Lash Group	Manufacturers	Reimbursement services for pharmaceutical, biotech and medical device companies
Premier Source	Manufacturers	Reimbursement and strategic consulting
TheraCom	Manufacturers	Commercialization and support services to biotech and pharma manufacturers
ABC Specialty Canada	Hospitals, manufacturers	Consulting services

Source: Company reports. *Included in AmerisourceBergen's "Other" Segment (AmerisourceBergen Consulting Services, or ABCS), and not in ABSG

Within the companies listed above, legacy ABSG provided services and distribution capabilities that span the life cycle of a specialty drug. The services provided by timing are outlined in Figure 5f

and described in more detail below.

Figure 5: ABSG Services across the Specialty Drug Lifecycle



Source: Company reports.

Manufacturer Services:

ABC provides a variety of logistics services that manufacturers outsource. We provide brief summaries of each below:

- Finished Goods Warehousing: For specialty products in particular, the necessity of time- and temperature-sensitive warehousing and distribution is very important. With cold-chain capabilities and constant monitoring, specialty distributors provide a value-added service to lower costs for manufacturers.
- Customer Services: ABC has call centers staffed with trained personnel that act in place of manufacturer customer service reps.
- Order Management: ABC uses advanced tracking to administer chargebacks, track inventory, manage invoices and accounts receivables and provide online access to product info.
- Inventory Management & Product Distribution: ABC's specialty distribution center is located near a UPS hub in Louisville, KY, with over 120,000 sq. ft. ABC managed lot control, expiration dates and emergencies, and provides online access to manufacturers to monitor real-time inventory and distribution.
- Sample and Marketing Material Fulfillment: In addition to drug distribution, ABC will also handle the distribution of product samples and marketing materials to manufacturer sales teams, physicians and pharmacists.
- Financial Services, A/R and Invoicing: As with non-specialty distribution, the balance sheet and credit rating of distributors provides them with a key service to manage accounts receivable risk. ABC provides similar services to specialty manufacturers as well.
- Other services: ABC provides other services for manufacturers, including consulting services, product awareness and marketing, reimbursement and patient support services.

Physician Services:
Legacy ABSG focused on distributing key drugs that are primarily dispensed in a physician office or clinical setting, including: >2,000 oncology products, blood plasma, vaccines, diagnostic test kits and reagents, various injectable products and some medical/surgical supplies. The company also offers physicians:

- Group Purchasing. Legacy ABSG had noted that it has the largest collection of physician networks in the U.S., spanning oncology, rheumatology, nephrology, and other specialties.
- Physician Practice Management: Legacy ABSG also provides services to physicians that take administrative burdens out of the physician office. Services offered include: office process development, benefits verification and coordination, medical necessity documentation, order and inventory management.
- Other services: ABC provides other services for physicians, including clinical and operational education, technology solutions and business consulting services.

Specialty Pharmacy
While the mainstay of AmerisourceBergen's specialty business is its distribution segment, the company also has a specialty pharmacy in which it deals with patients directly (US Bioservices). The pharmacy focuses on many of the large specialty disease states (such as rheumatoid arthritis, multiple sclerosis, hepatitis C, oral oncolytics, hemophilia/IVIG, and growth hormone) as well as a number of other diseases, including limited and sole source drugs, and utilizes pharmacists, nurses and patient counselors to address the unique needs of specialty patients.

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Investment Thesis, Valuation and Risks

AmerisourceBergen *(Neutral; Price Target: $105.00)*

Investment Thesis

Our rating on AmerisourceBergen is Neutral. We continue to point to a positive longer term fundamental outlook for the drug distribution industry, driven by an aging population and increased utilization of prescription drugs. We believe the core pharma distribution business is stabilizing, with several of the headwinds that have driven tough y/y comps now behind. ABC should see an incremental benefit from growth at key customers (such as Walgreens completing the Rite Aid asset purchase). Further, as the largest distributor of specialty drugs to community-based oncologists, we believe the company could potentially see an incremental benefit from biosimilar launches going forward. We also point to the potential for accretive uses of cash flow. However, we note that a higher level of generic deflation and longer than expected remediation efforts at PharMEDium represent potential risks.

Valuation

ABC shares trade at 12.8x our CY18 adjusted EPS estimate of $6.75. Our December 2018 price target of $105 is based on a 14.0x multiple on our CY19 adjusted EPS estimate of $7.51. This target multiple is just below the historical average forward P/E multiple for the pharma distributors of ~14.5x over the past 10 years and represents a discount to the market multiple.

Risks to Rating and Price Target

Several factors could cause the stock to outperform or underperform our expectations. These risks include higher or lower than anticipated drug price inflation, generic deflation, timing and dynamics of generic launches, competitive pricing pressure, potential contract wins or losses, a change in the interest rate environment, significant downward revision to the growth rate of the pharmaceutical industry, and changes in the healthcare regulatory environment.

AmerisourceBergen: Summary of Financials

Income Statement - Annual	FY16A	FY17A	FY18E	FY19E	FY20E
Revenue	**146,850**	**153,144**	**167,833**	**179,794**	**-**
COGS	(142,511)	(148,757)	(163,233)	(174,904)	-
Gross profit	**-**	**-**	**-**	**-**	**-**
SG&A	(2,091)	(2,129)	(2,272)	(2,399)	-
Adj. EBITDA	**2,248**	**2,258**	**2,328**	**2,491**	**-**
D&A	(217)	(241)	(270)	(272)	-
Adj. EBIT	**2,030**	**2,017**	**2,059**	**2,218**	**-**
Net Interest	(131)	(140)	(167)	(171)	-
Adj. PBT	**1,904**	**1,880**	**1,891**	**2,047**	**-**
Tax	(618)	(576)	(445)	(445)	-
Minority Interest	-	-	-	-	-
Adj. Net Income	**1,286**	**1,304**	**1,446**	**1,602**	**-**
Reported EPS	5.62	5.88	6.55	7.34	-
Adj. EPS	**5.62**	**5.88**	**6.55**	**7.34**	**-**
DPS	**1.26**	**1.45**	**1.51**	**1.65**	**-**
Payout ratio	22.4%	24.6%	23.1%	22.5%	-
Shares outstanding	229	222	221	218	-

Income Statement - Quarterly	1Q18A	2Q18E	3Q18E	4Q18E
Revenue	**40,466A**	**40,511**	**42,978**	**43,878**
COGS	(39,354)A	(39,310)	(41,856)	(42,713)
Gross profit	**-**	**-**	**-**	**-**
SG&A	(559)A	(567)	(560)	(587)
Adj. EBITDA	**554A**	**634**	**562**	**577**
D&A	(66)A	(69)	(67)	(68)
Adj. EBIT	**488A**	**566**	**495**	**510**
Net Interest	(36)A	(44)	(44)	(44)
Adj. PBT	**452A**	**522**	**451**	**466**
Tax	(110)A	(136)	(98)	(101)
Minority Interest	-	-	-	-
Adj. Net Income	**342A**	**386**	**353**	**365**
Reported EPS	1.55A	1.75	1.60	1.65
Adj. EPS	**1.55A**	**1.75**	**1.60**	**1.65**
DPS	**-**	**-**	**-**	**-**
Payout ratio	-	-	-	-
Shares outstanding	221A	221	221	221

Balance Sheet & Cash Flow Statement	FY16A	FY17A	FY18E	FY19E	FY20E
Cash and cash equivalents	2,742	2,435	3,354	4,157	-
Accounts receivable	9,176	10,303	10,887	11,637	-
Inventories	10,724	11,461	12,297	12,897	-
Other current assets	210	103	103	103	-
Current assets	**22,852**	**24,303**	**26,641**	**28,793**	**-**
PP&E	1,531	1,798	1,857	1,888	-
LT investments	-	-	-	-	-
Other non current assets	9,274	9,215	9,923	9,744	-
Total assets	**33,656**	**35,316**	**38,420**	**40,425**	**-**
Short term borrowings	611	12	20	20	-
Payables	23,926	25,404	26,695	27,945	-
Other short term liabilities	744	1,402	1,654	1,654	-
Current liabilities	**25,281**	**26,818**	**28,369**	**29,619**	**-**
Long-term debt	3,594	3,430	4,120	3,923	-
Other long term liabilities	2,651	3,004	3,004	3,004	-
Total liabilities	**31,527**	**33,252**	**35,492**	**36,546**	**-**
Shareholders' equity	2,129	2,064	2,928	3,879	-
Minority interests	-	-	-	-	-
Total liabilities & equity	**33,656**	**35,316**	**38,420**	**40,425**	**-**
BVPS	**-**	**-**	**-**	**-**	**-**
y/y Growth	-	-	-	-	-
Net debt/(cash)	1,464	1,007	786	(213)	-
Cash flow from operating activities	**3,178**	**1,504**	**1,790**	**1,990**	**-**
o/w Depreciation & amortization	365	398	444	448	-
o/w Changes in working capital	1,228	402	124	(100)	-
Cash flow from investing activities	**(3,169)**	**(498)**	**(1,209)**	**(300)**	**-**
o/w Capital expenditure	(465)	(466)	(325)	(300)	-
as % of sales	*0.3%*	*0.3%*	*0.2%*	*0.2%*	-
Cash flow from financing activities	**565**	**(1,313)**	**337**	**(887)**	**-**
o/w Dividends paid	(288)	(320)	(334)	(361)	-
o/w Net debt issued/(repaid)	712	(750)	698	(196)	-
Net change in cash	**574**	**(307)**	**919**	**803**	**-**
Adj. Free cash flow to firm	**2,803**	**1,135**	**1,593**	**1,824**	**-**
y/y Growth	*(25.2%)*	*(59.5%)*	*40.4%*	*14.5%*	-

Ratio Analysis	FY16A	FY17A	FY18E	FY19E	FY20E
Gross margin	-	-	-	-	-
EBITDA margin	1.5%	1.5%	1.4%	1.4%	-
EBIT margin	1.4%	1.3%	1.2%	1.2%	-
Net profit margin	0.9%	0.9%	0.9%	0.9%	-
ROE	93.7%	62.2%	57.9%	47.1%	-
ROA	4.2%	3.8%	3.9%	4.1%	-
ROCE	26.3%	23.6%	25.0%	23.3%	-
SG&A/Sales	1.4%	1.4%	1.4%	1.3%	-
Net debt/equity	68.7%	48.8%	26.8%	(5.5%)	-
P/E (x)	15.4	14.7	13.2	11.8	-
P/BV (x)	-	-	-	-	-
EV/EBITDA (x)	9.6	9.4	9.0	8.0	-
Dividend Yield	1.5%	1.7%	1.8%	1.9%	-
Sales/Assets (x)	4.8	4.4	4.6	4.6	-
Interest cover (x)	17.1	16.1	13.9	14.6	-
Operating leverage	86.1%	(15.5%)	21.5%	108.9%	-
Revenue y/y Growth	8.0%	4.3%	9.6%	7.1%	-
EBITDA y/y Growth	7.6%	0.5%	3.1%	7.0%	-
Tax rate	32.5%	30.7%	23.5%	21.8%	-
Adj. Net Income y/y Growth	12.7%	1.4%	10.9%	10.8%	-
EPS y/y Growth	13.4%	4.7%	11.3%	12.1%	-
DPS y/y Growth	8.6%	14.7%	4.7%	9.2%	-

Source: Company reports and J.P. Morgan estimates.
Note: $ in millions (except per-share data).Fiscal year ends Sep. o/w - out of which

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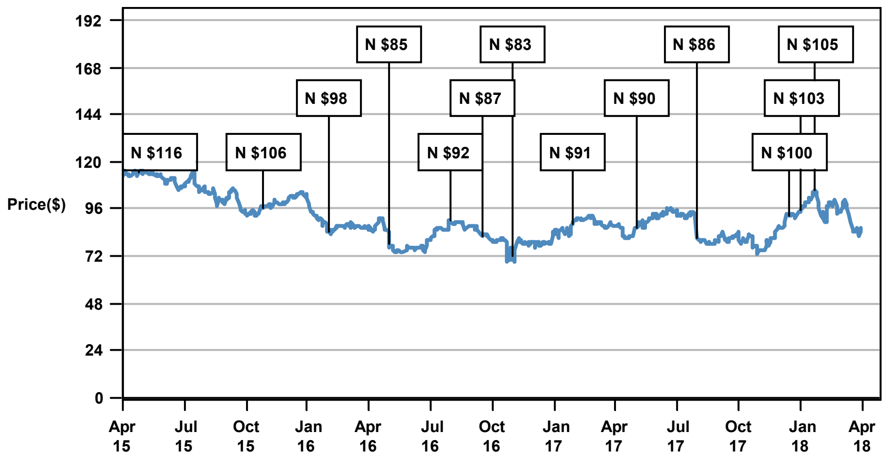
AmerisourceBergen (ABC, ABC US) Price Chart



Date	Rating	Share Price ($)	Price Target ($)
30-Apr-15	N	114.30	116.00
30-Oct-15	N	96.82	106.00
04-Feb-16	N	84.70	98.00
05-May-16	N	78.00	85.00
03-Aug-16	N	89.89	92.00
20-Sep-16	N	82.08	87.00
03-Nov-16	N	72.32	83.00
31-Jan-17	N	88.61	91.00
05-May-17	N	85.89	90.00
04-Aug-17	N	81.71	86.00
19-Dec-17	N	92.40	100.00
05-Jan-18	N	95.32	103.00
26-Jan-18	N	105.48	105.00

Source: Bloomberg and J.P. Morgan; price data adjusted for stock splits and dividends.
Initiated coverage Jun 11, 1999.

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