CVS Health

June 2024

Pacific Investment Research

Executive Summary

Company Overview

CVS Health is one of the largest healthcare services companies in the US, operating across retail, health insurance, and pharmacy benefit management. Originating as a beauty products retailer named Consumer Value Store, CVS ventured into pharmacy and developed into its current form through the 2008 merger with Caremark (PBM) and the 2018 merger with Aetna (insurance).

Chart of Revenue Composition

Table with relevant metrics: Market Cap, EBITDA Margin, P/E,

Thesis Summary

1. Market likely overreacted to cyclical insurance MLR pressure. Recovery & deleverage can drive multiple expansion
2. Pessimism of the viability of MA market is likely to subside after election. Enterprise remains strong to capture synergy.

Valuation Snapshot

YTD Stock performance

Health Care Benefits Segment: Health Insurance

Business Model

CVS Health Insurance operates **primarily through its Aetna subsidiary**, providing a range of health insurance products including medical, dental, and long-term care plans. Leveraging its extensive network of retail locations, the model **integrates in-person healthcare services with pharmacy services**, promoting a **holistic** approach to patient care.

Competitive Landscape

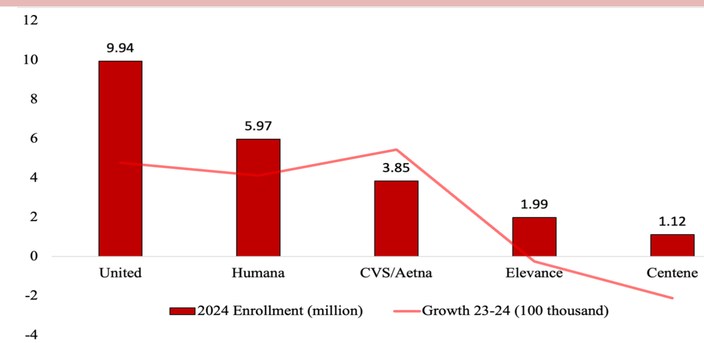
Overall, CVS Health is not significantly competitive in terms of **pricing**, however, due to its extensive network of locations and unique **integration with retail services**, it still has the **resilience and potential to growth** and compete in the market.

	Annual Cost	Coverage	Locations
Cigna	~$1000 min	Dental, pharmacy benefit, wellness	30+ countries, strong presence in the US
United Healthcare	~$5700 - ~$7550	Medicare, wellness, preventive care	National wide in the US
aetna	~$6000	Dental, behavioral health, medical, pharmacy	National wide in the US

Market Outlook

1. Rising MLR after COVID **may increase costs** related to chronic conditions during the pandemic may continue affecting health insurers' pricing and premium strategies
2. Switch to value-based care might **potentially stabilize or reduce MLRs** by incentivizing preventative care, leading to lower long-term costs
3. Negative sentiments towards 2025 MA efficiencies elsewhere to **offset the anticipated decrease** in reimbursement rates

Recent Performance



- Aetna added 544,000 enrollees from 2023 to 2024, growing to 3.9 million members in 2024.
- Consumer participation increased 25 percent to approximately 16 million from 2020 to 2022,coincident with extended enrollment periods and enhanced subsidies implemented under the American Rescue Plan Act of 2021 and extended through 2025 by the Inflation Reduction Act of 2022

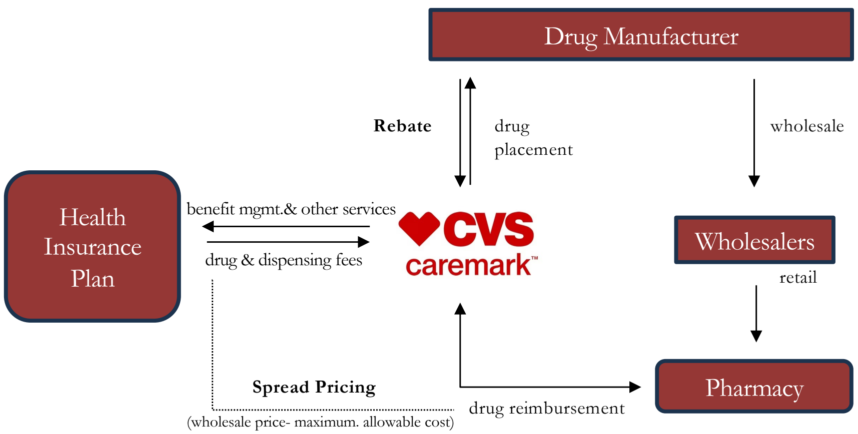
McKinsey Company; Axios Vitals

Health Services Segment: PBM & Care Delivery

Pharmacy Benefit Management

CVS Caremark is a leading PBM in the U.S., holding ~34% market share. Its revenue is recurring due to high switching costs. The market is concentrated, with Caremark, Express Scripts, and OptumRx controlling ~80%.

Revenue is generated through:
Rebate: Earning commission from Pharma for including drugs on insurance plan's formulary.
Spread Pricing: Negotiate lower price with pharmacies and charge higher to insurer.



Care Delivery

The care delivery segment aims to provide more integrated, convenient, and personalized healthcare services. This multifaceted business has significant potential to drive the company's future earnings growth.

minute clinic	Oak St. Health	signifyhealth
A network of clinics within CVS pharmacies that offers easily accessible, walk-in medical services for routine care and basic health screenings.	Primary care centers that focus on delivering preventative healthcare for senior Medicare beneficiaries.	A platform connecting 11k+ licensed clinicians with over 2.5m patients to provide telehealth and in-home medical services.

Industry Trend

Push Towards Greater Transparency: Scrutiny from federal agencies and competition from Mark Cuban's Cost Plus Drug Co. are pushing PBMs to enhance price transparency. CVS introduced new pricing model TrueCost for simplified cost-based pricing.

Rise of Home-Based Care & New Entrants: The aging population and growing demand for more accessible, convenient healthcare services are driving the shift towards home-based care models. Major retailers like Walmart and Amazon are also entering into the market, leveraging their data analytic capabilities.

Pharmacy & Consumer Wellness Segment: Retail & Pharmacy Services

Retail

Key Components

CVS stores typically offer a wide range of products including beauty products, personal care items, food, and general merchandise. This part of the business is designed to drive traffic to the stores, thereby increasing prescription and front-store sales.

Key Resources

- 9,700 retail locations
- 68,000 retail pharmacy networks
- Network, presence & brand

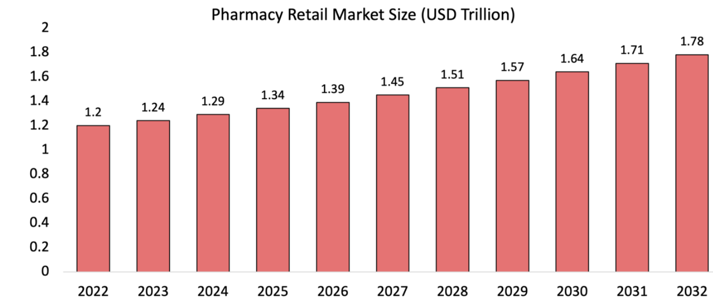
Channels

- Stores
- Chained pharmacies
- Independent pharmacies
- Hospitals

Consumer Segment

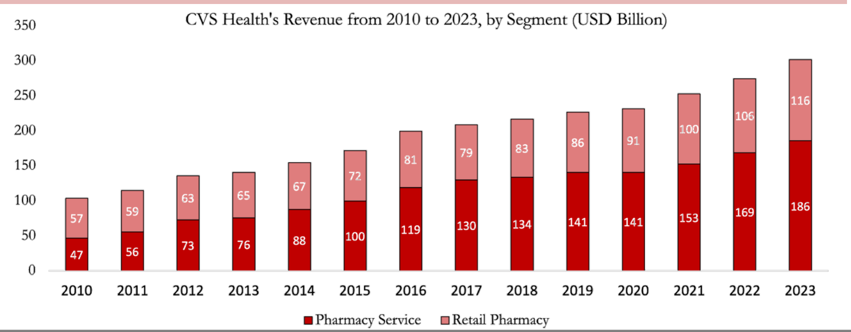
- Daily shoppers (main)
- Employees & Unions
- Health plans

Industry Trends



The **global** pharmacy market was estimated at US$ 1.20 trillion in 2022 and is expected to hit around US$ 1.78 trillion by 2032, poised to grow at a **CAGR of 4.10%** during the forecast period 2023 to 2032.

Recent Performance



Trends

1. Between 2018 and 2020, CVS **closed** 244 stores and announced plans in 2021 to close 900 more by 2024.
2. CostVantage model aims to **make CVS's earnings more predictable** by focusing on healthcare services, which tend to provide more stable and recurring revenue compared to retail sales. It is a response to the competitive pressures from other retail and online giants like Amazon and big-box stores that have been encroaching on traditional pharmacy sales.
3. CVS has been successfully **expanding its market share** at the expense of competitors like Walgreens and Rite Aid, capitalizing on strategic decisions that leverage its expanding healthcare services and its comprehensive management of health-related services across its network.

Recent Performance: Easing Growth Momentum & Rising Healthcare Costs

Down 28.7% YTD and 18.9% in past year driven by:

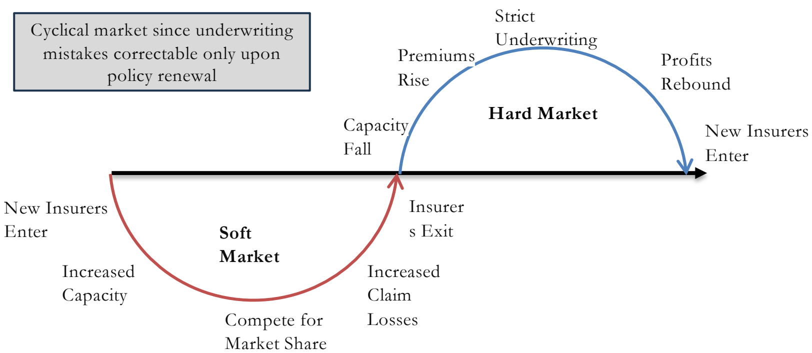
- Increased utilizations and medical costs & guidance revision
- Disappointing Medicare Advantage rate increase
- Previously, easing Covid-induced demand for vaccines & medicines

24E Metric	Previous	Revised	Change
CVS Consolidated			
Revenue	>$371.3B	>$369.0B	-1%
Operating Income	>$16.9B	>$14.8B	-13%
EPS	$7.06	$5.64	-20%
Adj. EPS	$8.30	$7.00	-16%
Health Care Benefits			
Revenue	>$125.1B	>$129.1B	3%
Operating Income	>$5.4B	>$3.6B	-33%
MLR	>87.7%	>89.8%	210bps
Health Services			
Revenue	>$169.7B	>$167.0B	-2%
Operating Income	>$7.4B	>$7.0B	-5%
Pharmacy & Wellness			
Revenue	>$123.4B	>$122.4B	-1%
Operating Income	>$5.6B	>$5.6B	0%

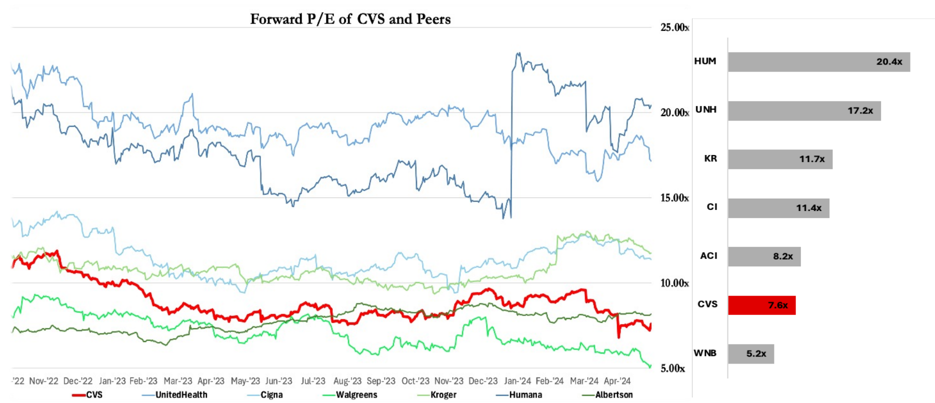
Thesis I: Market Rerating from Normalizing Cyclical Pressures

CVS faces challenges and remain priced closer to its retail peers at 8x PE. However, many headwinds appear short-termed. Rebounds across high multiple insurance segment can drive rerating, returning the company's valuation to that of an integrated healthcare company.

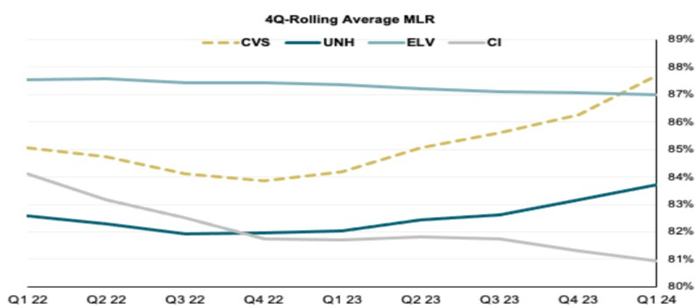
Insurance Market: Short-Term Volatility & Long-Term Growth



Anticipated Sector Rebound Following Market Overcorrection



CVS Punished for Prior Years of Overly Aggressive Member Acquisitions



- Management has many levers to improve earnings: increasing premiums, slashing benefits over years, shedding non-compliant members, etc.

Recent Rerating Catalysts

- **Normalization of Medical Claims**: delayed medical procedures from the pandemic and seasonal flu contributed ~900M incremental medical claim expense. Future normalizing trend is a tailwind.
- **CMS Quality Bonus**: anticipate ~700M earning improvement from recapturing star rating in 2024.

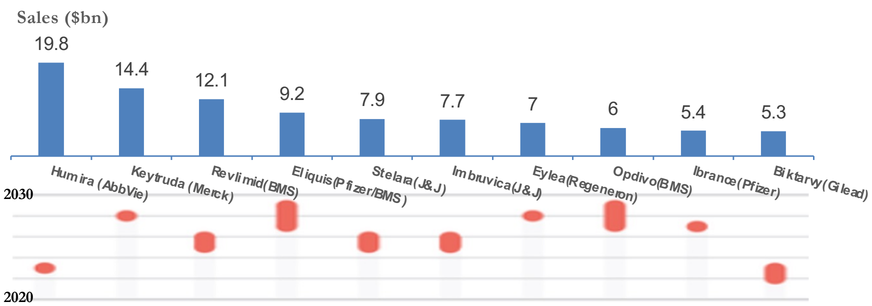
Thesis I: Market Rerating from Normalizing Cyclical Pressures

With potential upside opportunities across Health Service and Retail segments, continued deleveraging can drive multiple expansion. Plus, a ~4.5% dividend payout ratios will become increasingly attractive in Fed's easing cycle.

Health Service

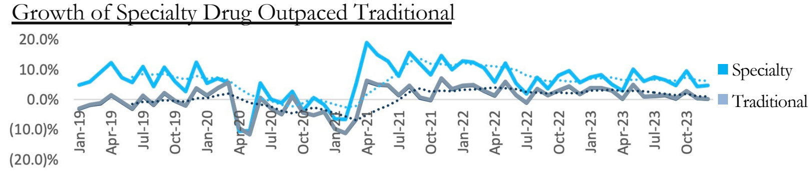
Despite losing a major contract in Q1 2024, PBM business, with leading retail footprint, remains the preferred choice due to its ability to secure volume-based discounts from drug manufacturers and provide convenient services for insurance plan members.

- Biosimilar venture, Cordavis, is expected to add 1~2% to earnings through commercializing blockbuster drugs Humira and Stelara and benefit from "patent cliff"



- Growing Biotech pipeline of specialty drug and increasing utilization and coverage of GLP-1 drugs can improve margins

Growth of Specialty Drug Outpaced Traditional



Retail

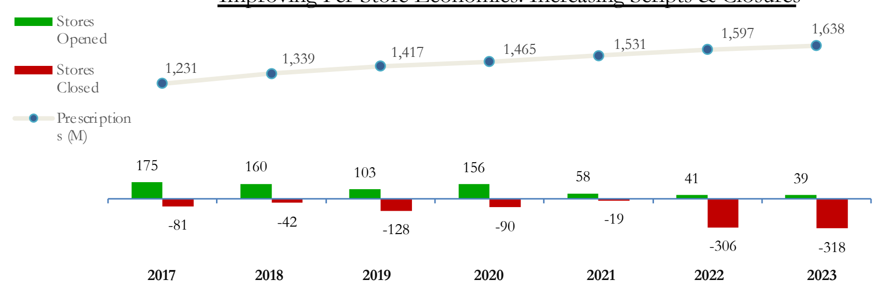
Shrinkage and competition should persist but in long-term:

- Continued store closure from RiteAid and Walgreens and CVS's own optimization plan should improve per-store revenue and earnings

- Phase-in of CostVantage will replace the complex, opaque reimbursement model, stabilizing pharmacy margins from unexpected squeezes

- Entry of Amazon Pharmacy could pose substantial threats, but brand familiarity and older customers means many would still rely on legacy drug stores and its direct-to-home mail-in dispensing
- Transformation of retail stores into HealthHUB, healthcare delivery and screening centers, will provide a competitive advantage over online-only players.

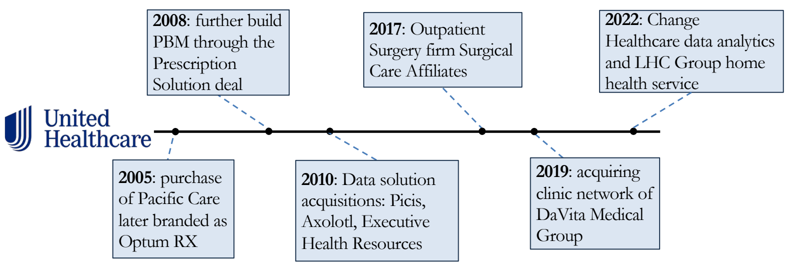
Improving Per-Store Economics: Increasing Scripts & Closures



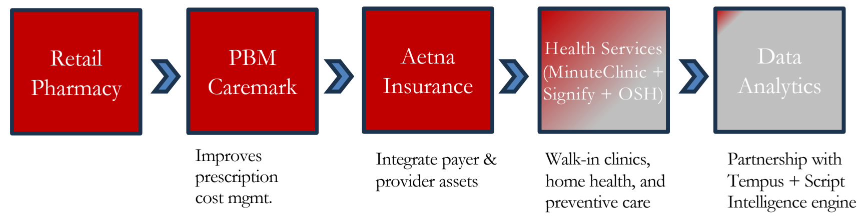
Thesis II: Value-Based Care Model Remains Robust and Positioned to Capture Synergies

The vertical integration of primary care, chronic care services, and pharmacy networks at CVS is strategically designed to improve risk-coding accuracy and enhance patient outcomes. The vertical integration is proven effective in reducing healthcare costs below premiums and government payments, thereby sustaining a profitable margin.

Pursuit of Vertical Integration by Healthcare Conglomerates

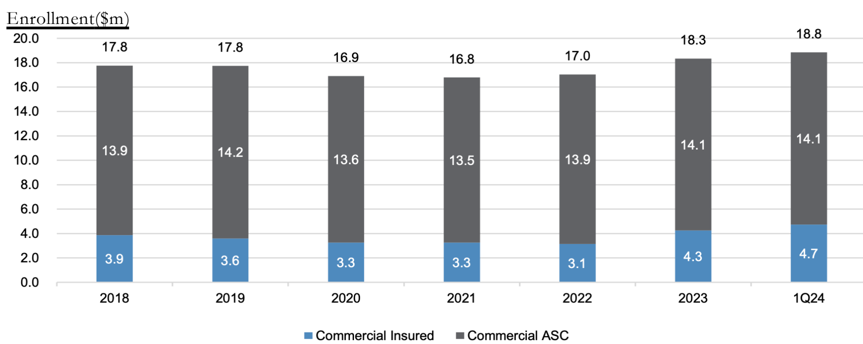


CVS's Path from Retail to MCO

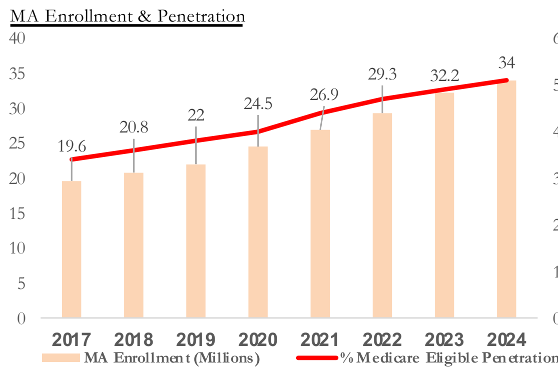


Differentiated Offering Drives Commercial Insurance Growth

Low single-digit long term growth through higher margin fully-insured plans



Favorable Demographic Trend and MA Penetration Rate



-Baby Boomers aging into the program at ~10,000 individuals per day

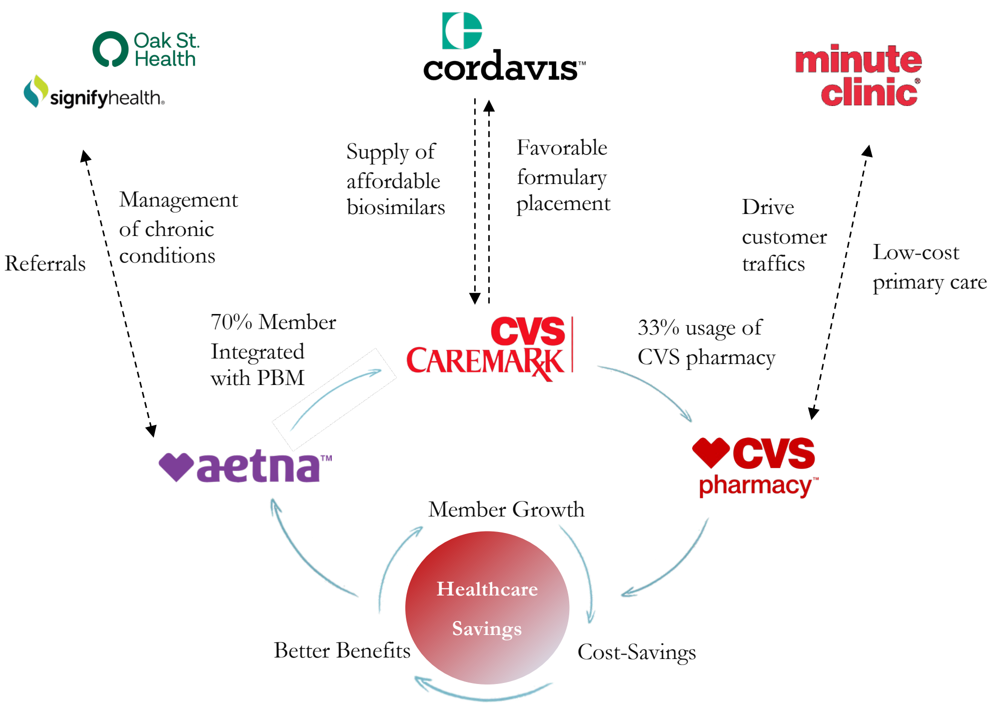
- MA plans are preferred, evidenced by the consistently growing penetration rate

- Longer life expectancy increase demand for healthcare services

- Seniors 65+ are expected to grow from 58m to 82m in 2025.

Thesis II: Value-Based Care Model Remains Robust and Positioned to Capture Synergies

CVS's integration of Medical Coverage, Pharmacy Coverage, and Primary Care can drive down healthcare costs in long term.



Studies found integrated medical and pharmacy benefit offerings generates cost saving and contains cost growth:

3-6% PMPM*

- **18% fewer hospitalizations**
- **10% fewer ER visits**
- **+4% non-urgent gaps-in-care closure rate**
- **+6% drug adherence rates**

Leveraging AI Predictive Capabilities:

- Learning of health records and refill patterns can enhance disease detection, allowing for preemptive care intervention before escalation

- Better telehealth services and patient engagement can improve adherence and health monitoring

- Automating administrative tasks in pharmacies to improve script volume and operating efficiency

Synergy & Network Effects:

- Scaling operations and building care provider assets at given localities can attract more clients by offering superior benefits

- Cross-selling opportunity: increase cross-enrollment of Aetna member into Caremark BPM, referring plan enrollees into health management and delivery network, filling PBM prescriptions from CVS pharmacy

- PBM will gain greater negotiating power over rebates and pricing with more extensive retail network and formulary control

Risks: PBM Regulatory Scrutiny & MA Political Reform

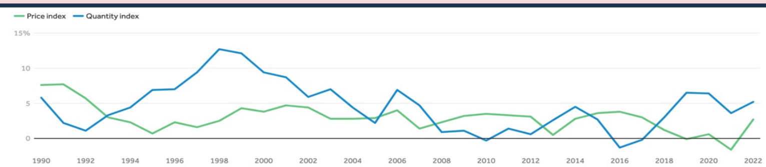
Controversy Over PBM's True Value-Add

Risks

- Market consolidation and opaque pricing structure prompted Federal Trade Commission (FTC) to launched investigations into PBMs in July 2022.
- With bipartisan support on lowering drug costs, regulators may crack down on PBMs to reduce patient out-of-pocket spending in the future.

Mitigants

- FTC previously found no anti-competitive concerns and various studies proved PBM's ability in reducing drug costs. Moreover, CVS claims 98% of rebates are passed on to clients in 2023.
- Only a fraction of PBM regulation got passed and none singly altered PBM operations
- CVS's push for greater transparency, the TrueCost Program, is well-received.



<u>%total proposal for BPM regulation passed</u>

	2016	2017	2018	2019	2020	2021	2022	2023	2024*	Total
Passed State Legislation Around PBMs	9	7	32	33	20	23	17	22	11	174
Total Proposed State Legislation Around PBMs	91	103	179	302	434	318	292	139	164	2022
% of Total Proposed Legislation Passed	9.9%	6.8%	17.9%	10.9%	4.6%	7.2%	5.8%	15.8%	6.7%	8.6%

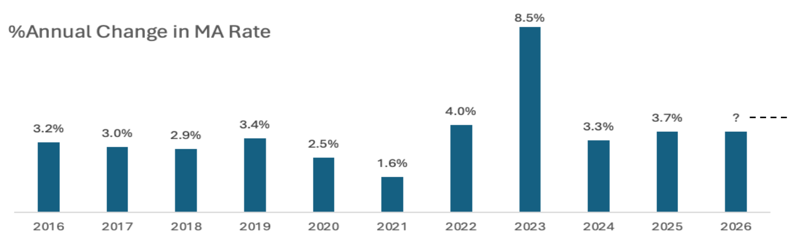
Political Reforms Targeting MA Market

Risks

- MA The Medicare Advantage market has traditionally been profitable, yet increasing scrutiny over perceived excessive government payments poses potential risks to its sustainability.

Mitigants

- Rhetoric to tighten over-spending may moderate after election when fiscal assessments and negotiation take
- Presidential candidates have relatively favorable policy proposal impacting MA



Biden: - Tightened rate in 2025
- Lower Medicare eligible age
- Push for expansion of Medicare under ACA

Mixed Signals

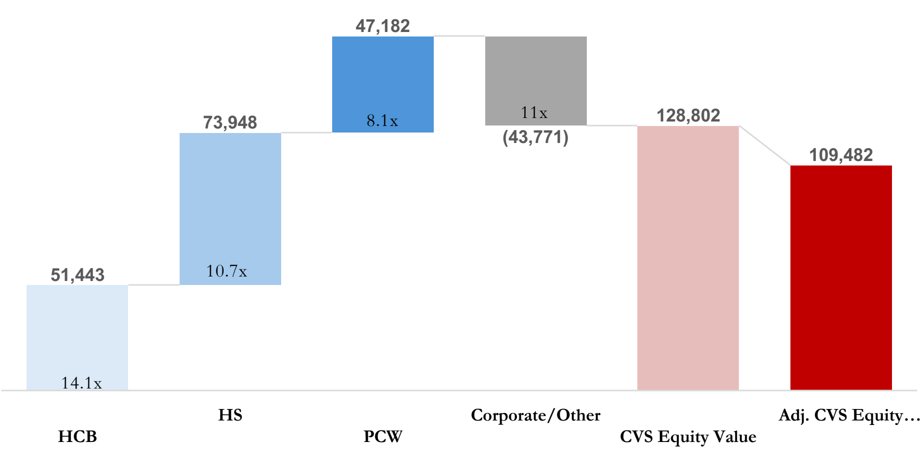
Trump: - Expanded enrollees from 17m to 24.5m
- Proponent of privatizing Medicare

Likely Supportive

Valuation: SOTP

	Insurance					PBM	Retail		
	United Healthcare	Cigna	Elevance Health	Humana	CENTENE Corporation	EXPRESS SCRIPTS®	Walgreens	Kroger	Albertsons
EV/ EBIT	16.1x	16.1x	14.3x	12.6x	7.8x	12.7x	25.7x	11x	11x
NTM PE	17.9x	11.5x	14.1x	21.2x	9.9x	10.7x	5.4x	11.7x	8.1x

Equity Value Based on Projected Earnings 2027



	Insurance - EV/EBIT	Insurance - NTM PE	PBM - EV/EBIT	PBM - NTM PE	Retail - EV/EBIT	Retail - PE
Average	13.4x	14.9x	12.7x	10.7x	15.9x	8.4x
Median	14.3x	14.1x	12.7x	10.7x	11.0x	8.1x

Valuation - PE				
Fiscal Year End December	**2025E**	**2026E**	**2027E**	**2028E**
Segment Equity Value				
HCB (Insurance)	36,583	45,986	51,443	58,671
HS (PBM)	65,648	69,933	73,948	77,939
PCW (Retail)	51,501	46,106	47,182	48,291
Corporate/Other	(38,607)	(41,206)	(43,771)	(46,471)
CVS Equity Value	115,125	120,819	128,802	138,431
Congolmerate Discount	15%	15%	15%	15%
Adj. CVS Equity Value	97,856	102,696	109,482	117,666
Fair Price per Share	$77.2	$81.1	$86.4	$92.9

Valuation: DCF & DDM

Cash Flow								
	Historicals			Forecasts				
Fiscal Year End December	2021A	2022A	2023A	2024 Stub	2025E	2026E	2027E	2028E
EBIT	**12,440**	**7,614**	**13,743**	**6,638**	**11,080**	**11,627**	**12,396**	**13,322**
NOPAT	**9,161**	**5,523**	**10,293**	4,750	**8,165**	**8,569**	**9,135**	**9,818**
(+) D&A	4,486	4,224	4,366	3,197	4,644	4,957	5,266	5,590
(+) Loss on asset held for sale	0	2,533	349	0	0	0	0	0
(+) Store Impairments	1,358	0	0	0	0	0	0	0
(+) Goodwill Impairment	431	0	0	0	0	0	0	0
(-) Gain on Sale of Subsidiaries	0	475	0	0	0	0	0	0
(+) Loss on Early Extingusihment of Debt	452	0	0	0	0	0	0	0
(+) Deferred Income Taxes	(402)	(2,029)	(676)	0	0	0	0	0
(+/-) Other Noncash Items	(390)	332	416	0	0	0	0	0
(+/-) Changes in Working Capital	3,857	6,818	15	(2,346)	(912)	(959)	(993)	(1,112)
(-) Cap Ex	(2,520)	(2,727)	(3,031)	(2,233)	(3,148)	(3,360)	(3,569)	(3,789)
UFCF	**16,433**	**15,149**	**11,732**	**3,368**	**8,750**	**9,207**	**9,839**	**10,507**
End-of-Year Discount Period				0.6	1.6	2.6	3.6	4.6
Mid-Year Discount Period				0.3	1.1	2.1	3.1	4.1
PV of Projected UFCF				**$3,304**	**$8,139**	**$8,002**	**$7,989**	**$7,972**

Dividend Discount Model											
Quarters	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**
Dividend Payout	$1.1	$1.4	$1.7	$2.0	$2.0	$2.0	$2.0	$2.0	$2.2	$2.4	$2.7
Growth Rate		27.3%	21.4%	17.6%	0.0%	0.0%	0.0%	0.0%	10.0%	10.0%	9.9%
Average Growth	9.6%										
Growth Rate	5.0%										
Cost of Equity	9.2%										
Fair Price per Share	$65.9										

				Cost of Equity		
	$65.9	7.2%	8.2%	9.2%	10.2%	11.2%
	4.0%	$86.5	$65.9	$52.8	$44.6	$38.4
	4.5%	$103.0	$75.1	$58.6	$48.8	$41.5
Dividend Growth	5.0%	$127.0	$87.3	$65.9	$53.7	$45.0
	5.5%	$165.1	$103.9	$75.0	$59.7	$49.2
	6.0%	$235.0	$128.2	$87.0	$67.1	$54.2

Perpetuity Growth Method	
Terminal Year UFCF	$10,507
Perpertuity Growth Rate %	2.00 %
Terminal Value	**$213,208**
PV of Terminal Value	161,760
(+) PV of Projected UFCF	35,405
Intrinsic Enterprise Value	**$197,165**
(-) Net Debt	(68,703)
(-) Non-Controlling Interest	(182)
Intrinsic Equity Value	**$128,280**
(/) Fully-Diluted Shares Outstanding	1,267
Intrinsic Value per Share	**$101.2**
Margin of Safety	*39.0 %*

Terminal Multiple Method	
Terminal Year LTM EBITDA	$18,913
Terminal EV / LTM EBITDA Multiple	10.0 x
Terminal Value	**$189,128**
PV of Terminal Value	143,491
(+) PV of Projected UFCF	35,405
Intrinsic Enterprise Value	**$178,896**
(-) Debt Outstanding	(68,703)
(-) Non-Controlling Interest	(182)
Intrinsic Equity Value	**$110,011**
(/) Fully-Diluted Shares Outstanding	1,267
Intrinsic Value per Share	**$86.8**
Margin of Safety	*28.8 %*

				WACC		
	$101.2	6.0%	6.5%	7.0%	7.5%	8.0%
	3%	$196.7	$161.2	$134.5	$113.8	$97.1
	2.50%	$164.2	$137.1	$116.0	$99.2	$85.3
Terminal Growth Rate	2.00 %	$139.8	$118.4	$101.2	$87.2	$75.5
	1.50%	$120.8	$103.4	$89.1	$77.2	$67.2
	1%	$105.5	$91.1	$79.0	$68.8	$60.1

				WACC		
	$86.8	6.0%	6.5%	7.0%	7.5%	8.0%
	12x	$115.4	$112.4	$109.5	$106.6	$103.8
	11x	$103.6	$100.9	$98.2	$95.5	$92.9
Terminal EV/EBITDA	10x	$91.9	$89.3	$86.8	$84.4	$82.0
	9x	$80.1	$77.8	$75.5	$73.3	$71.1
	8x	$68.3	$66.2	$64.2	$62.2	$60.2