McKesson's operating consistency makes it a buy for CUSP managers

By Henry Lewis II and Colin McCabe

The CUSP managers voted to buy McKesson Corporation (MCK) in March of 2023. McKesson Corporation is the nation's leading pharmaceutical drug and medical device distributor. Its $267 billion in revenues makes McKesson one of the top 10 largest corporations in America. The company orders products directly from manufacturers, selling them to hospitals, pharmacies and other care providers. McKesson also sells some of its own products, such as gloves and masks, as well. The firm operates four business lines: Med-Surg Solutions, Prescription Tech Solutions, U.S. Pharmaceutical and International. U.S. Pharmaceutical and International are the firms two largest segments, comprising roughly 93% of revenues. U.S. Pharmaceutical has a 3-year growth rate of 8.5%, and the firm's total revenues have grown 28.5% over the past four years. McKesson has consistently grown revenue 5-7% each year for the past 10 years beyond that.

McKesson is classified as a healthcare supply chain company and a part of the overall Healthcare sector. The past several years for the healthcare supply chain sub-sector is characterized by opioid-related litigation, COVID-19-related volume disruptions and increasing prescription volume. Opioid-related litigation created significant uncertainty amongst distributors, but now that the settlement of $19.4 billion is concrete, the path forward is clear. As part of the resolution, McKesson is required to pay $7.4 billion over the next 18 years. Tailwinds for McKesson include increasing prescription volume, an aging populace and the genericization of Humira (Bloomberg). Providers continually write more prescriptions each year due to increased care access and range of effective options. Americans generally require more care and more prescriptions as they age, therefore driving additional increases in the firm's top line.

The CUSP views McKesson as somewhat of a defensive play, albeit one that exhibits consistent growth. Consumers and other organizations cannot function without the vital role McKesson plays. From a portfolio perspective, MCK provides some diversification for the CUSP positions in biotech firms. 13.79% of the CUSP is invested in healthcare, with 5.07% invested in biotech as a subsector.

McKesson recently completed the sale of the firm's European and Australian operations as a part of a years-long restructuring plan. The objective was to refocus on higher margin and higher growth areas of the business, such as Prescription Tech Solutions. Prescription Tech's operating margin of 17.14% helps offset the lower 4.8% operating margin of U.S. Pharma and Med-Surg Solutions departments. We believe McKesson will increase operating margins in the near term, leading to an increase in EPS over the next two-three years.

CUSP managers viewed McKesson as reasonably valued at the time of purchase. The firm traded at a P/E of 14.75, squarely in the middle of its peers, while also sporting the second-best PEG ratio. McKesson was also more profitable than its peers on many metrics. Our intrinsic valuation analysis of the firm, generally in line with the valuations reported by professional analysts in Bloomberg, suggested enough potential upside in stock price to justify purchase.

At the time of purchase, the CUSP's healthcare holdings were underweight the Russell 1000 benchmark by 1.5%. Proceeds from the sale of Horizon Therapeutics, cash on hand and the trimmings from the rebalancing of Vertex Pharmaceuticals and Regeneron Pharmaceuticals funded McKesson's purchase. CUSP managers also evaluated CVS but ultimately decided upon McKesson due to the prospects for the firm.