MIZUHO Mizuho Securities USA LLC

Healthcare Research
Healthcare Services
Industry Commentary

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AMZN Potential Entry Into Pharmacy Market Not as Scary as it Sounds

Summary

We would be buyers of CVS and WBA on today's weakness related to a press report that AMZN is considering entering the pharmacy market. While we believe AMZN has the monetary resources to enter the space, we do not think AMZN's entry would be market disruptive given: 1) mail order already exists; and 2) it is unlikely AMZN could garner generic discounts greater than CVS and WBA already offer. Given the regulatory, payer and generational hurdles, we do not think the investment AMZN would need to make would garner the meaningful ROIC it typically enjoys and expects.

Company	Symbol	Price (5/16)	Rating Prior	Rating Curr	PT
CVS Health	CVS	$79.12	–	Buy	$90.00
Walgreens Boots Alliance, Inc.	WBA	$84.51	–	Buy	$94.00

Source: Bloomberg and Mizuho Securities USA

Key Points

- **Hiring activity not surprising.** According to the reports, AMZN decided to hire a GM to oversee the pharmacy effort, as well as other people from the pharmacy sector. This activity is not surprising to us if AMZN is serious about entering the pharmacy market given any entry would need to be organic (there is no obvious asset to buy) and any investment would be significant. This reminds us of when WBA built up an internal "distribution" team about 6-8 years ago but eventually shuttered the group once the company realized that the drug manufactures only wanted to deal with the drug distributors.

- **While we believe AMZN has the resources to enter the pharmacy market, we do not think AMZN's entry would be market disruptive.** Given: 1) mail order already exists; and 2) it is unlikely AMZN could garner generic discounts greater than CVS and WBA already offer. We also think AMZN would face major infrastructure, payer and regulatory hurdles and it would be a major process for AMZN. Even if AMZN decides to make the investment, we still only view AMZN as a long-term threat due to the generational gap and the fact seniors (who are the highest consumers of prescription drugs) want personal care from their local pharmacists.

- **Mail order already exists so AMZN entry would not be a game-changer for the industry**. All major PBMs already offer home delivery, which is usually driven by plan design dictated by their employers. Mail order penetration has been flat to slightly down over the past five years. Interestingly, when CVS Caremark introduced Maintenance Choice, there was a trend out of mail back into retail because people like going to retail pharmacies to get their drugs.

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Could AMZN Enter The Pharmacy Market? Maybe. Would it Be Disruptive to CVS and WBA? Probably Not.

We would be buyers of CVS and WBA on today's weakness related to a press report that Amazon (AMZN, not covered) is considering entering the pharmacy market. While we believe AMZN has the monetary resources to enter the space, we do not think AMZN's entry would be market disruptive given: 1) mail order already exists; and 2) it is unlikely AMZN could garner generic discounts greater than CVS and WBA already offer. Given the regulatory, payer and generational hurdles (the majority of drugs dispensed to seniors), we do not think the investment AMZN would need to make would garner a meaningful ROIC for the company.

Amazon Threat Likely Minimal in Near Term

According to press reports, AMZN is deciding whether or not the company should enter the pharmacy market, but noted no final decision has been made. While we think it is reasonable that AMZN is looking at entering the market (and we would note not a relatively new development as this has been speculated about several times over the past decade), we do not view a potential move by the company as a major disruptor for the industry, especially in the near term. First, mail order already exists via the PBMs and mail order penetration has been stagnating over the past decade. Additionally, we believe AMZN would face significant regulatory, infrastructure and payer challenges, as well as clear generational barriers as individuals over 65 are the greatest consumers of prescriptions drugs.

Will AMZN Enter The Pharmacy Market?

It is possible but strategically we view as unlikely and, if it does happen, we do not think AMZN's entrance would be disruptive to the current system. According to the press reports, AMZN decided to hire a GM to oversee the effort, and the company also has hired other people from the pharmacy sector. The hiring activity is not surprising to us if AMZN is serious about entering the pharmacy market given any entry would need to be organic (there is no obvious asset to buy) and any investment would be significant. This reminds us of when WBA built up an internal "distribution" team about 6-8 years ago. At the time, WBA was hoping to bypass the drug distributors and created an internal group to see if the venture was possible. Eventually WBA shuttered the group once the company realized that the drug manufactures only wanted to deal with the drug distributors.

AMZN certainly has the financial means to make the investment (which would require an internal build-out as there is no mail pharmacies AMZN could buy). The question we have is whether or not the investment would garner enough ROIC that AMZN typically enjoys and for that matter, expects. We would highlight a few key points as why we would view the investment by AMZN as unlikely:

- **The retail pharmacy industry is HIGHLY regulated, both from a state and federal level**. While we again acknowledge AMZN's resources, we think the company would face major infrastructure and regulatory hurdles if it were to compete in the pharmacy industry and it would be a major process for AMZN. On the infrastructure side, the company would need to work with thousands of payers (managed care companies, PBMs and the Medicare Part D plans), negotiate with manufacturers and change plan designs with payers to allow payment via Amazon, a major undertaking that in our view would take several years. In addition, the industry is highly regulated from both a state and Federal level. We believe the company would face major challenges entering such a regulated market. Prescription transfer laws and e-prescribing make it significantly more challenging than the company's current retail offerings. While the article points out that AMZN recently expanded its Prime Now delivery service to include drug and cosmetic sales in Japan, with the support of local partners, the process is significantly more regulated in the U.S. than in foreign markets and we anticipate this would be a significant barrier to entry.

- **Gross margins in the pharmacy sector are attractive (~30%), but are coming down due to reimbursement pressures from the government side and managed care**. Further, the growth dynamics in the industry are decelerating due to the lack of new generic introductions, which has been a meaningful source of growth for the entire supply chain over the past decade as major chronic branded drugs (i.e. think Lipitor) went generic. As a result of this generic wave waning, we estimate operating profit growth for the industry is in the low-single digit range, from high-single digit growth during the generic conversion wave.

- **Mail order already exists so AMZN entry would not be a game-changer for the industry.** All major PBMs already offer home delivery, which is usually driven by plan design dictated by their employers. Mail order penetration has been flat to slight down over the past five years. Interestingly, when CVS Caremark introduced Maintenance Choice (which allows clients to get a 90-day retail prescriptions at retail instead of mail for the same economics), there was a trend out of mail back into retail because people like going to retail pharmacies go get their drugs. Especially seniors, who want personal care from their pharmacists.

- **Generational gap.** Even if AMZN were to be able to break through regulatory and infrastructure challenges, we still only view AMZN as a long-term threat due to the generational gap and likely lack of market share gains. According the CDC, roughly 89% of adults 65 or older use at least once prescription in a 30-day period, versus 67% in 45-64 year age group only 38% in the 18-44 age group. And for the 65 year older, this population tends to fill multiple drugs per month, averaging 20-25 per year, versus only 13 per year below the age of 50. Seniors drive the majority of pharmaceutical spend. However, the current senior population is not as tech savvy and would unlikely be interested in an AMZN based model, in our view. According to PEW Research only 42% of individuals over the age of 65 use a smartphone. By no means do we want to downplay this competitive threat, but we do not view it as a real threat over the next decade as we do not think it is feasible for the company to gain market share in that age bracket.

- **Generic buying.** WBA is the largest generic purchaser in the world (via its WBAD purchasing JV with WBA U.S, Alliance Boots ex-U.S and ABC), followed by CVS and CAH's RedOak JV. We do not foresee any scenario that AMZN gains enough market share that it would become a better purchaser of generic drugs than these established companies. A good example of this would be when Walmart (WMT, not covered) introduced its $4 generic program, which fizzled given the lack of market share gains. Generics are already a commodity product. With brand pharmaceutical purchasing, it does not matter how big the purchaser is, there are minimal price negotiations with the brand manufacturers.

In conclusion, we view the weakness today related to this news story as buying opportunities for both CVS and WBA. Our price target on CVS is $90 and $94 on WBA.

Price Target Calculation and Key Risks

CVS Health

Our valuation of $90 assumes the company will trade at a mixed valuation of a free cash flow yield of 6% based on 2017E adjusted FCF and a 13.5x PE. Risks include continued soft prescription volume due to the economy, market share shifts resulting from the introduction of health reform, loss of key client contracts, increased government regulation, industry pricing pressure and increased competition.

Walgreens Boots Alliance, Inc.

Our valuation of $94 is based on WBA stand-alone using a mix of PE (16x our FY17E) and cash flow (6% FCF on FY17E). Risk to valuation include exclusion of pharmacy benefit manager (PBM) provider networks, sales pressures due to the economy, increased government regulation, changes to pricing benchmarks, European exposure with the Alliance Boots acquisition and the FTC approval of the pending acquisition of RAD.

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Investment Risks and Valuation Methods can be located in the following section of this research report - Price Target Calculation and Key Risks.

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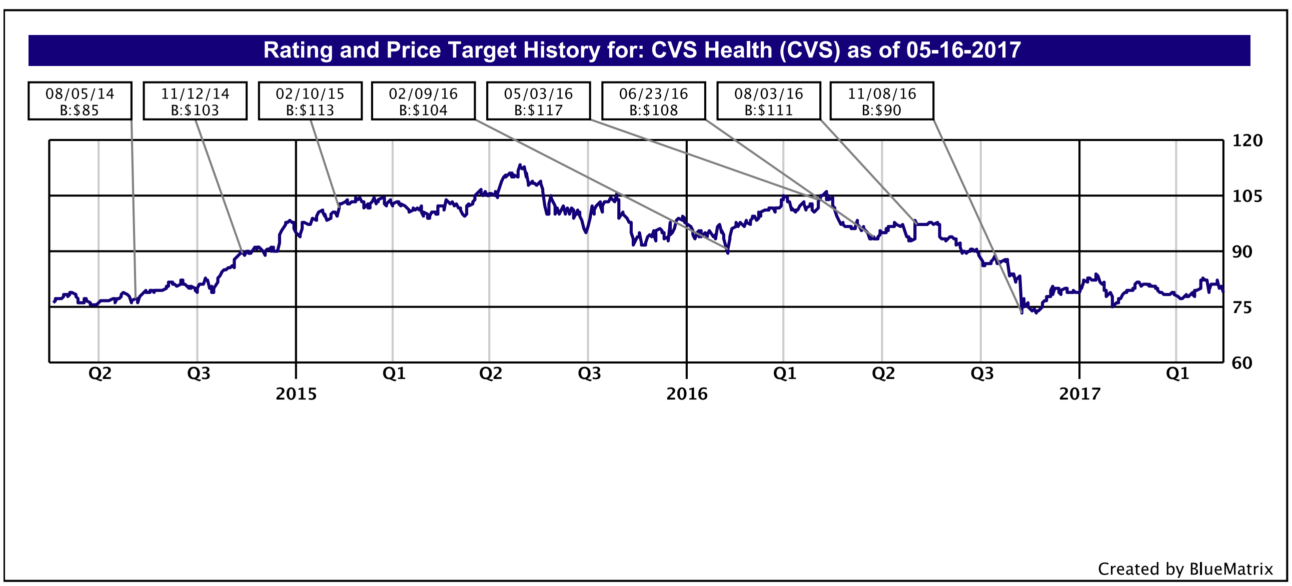
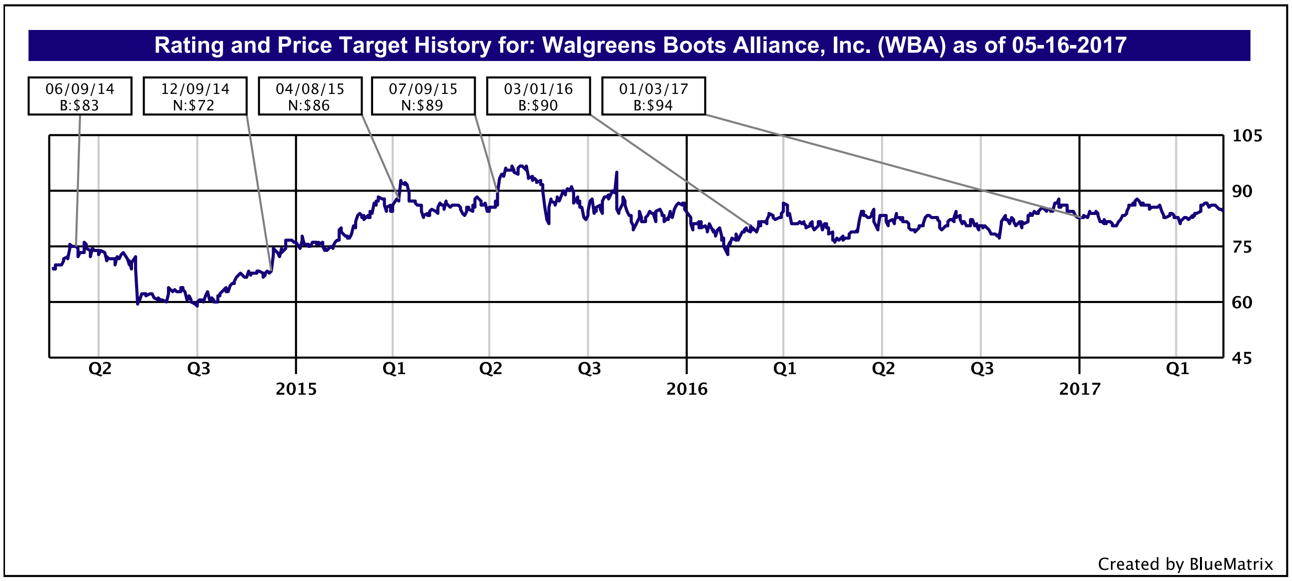
Underperform:	Stocks for which the anticipated share price falls by 10% or more.
RS:	Rating Suspended - rating and price objective temporarily suspended.
NR:	No Rating - not covered, and therefore not assigned a rating.

Rating Distribution

(As of 5/16)	**% of coverage**	**IB service past 12 mo**
Buy (Buy)	44.62%	50.00%
Hold (Neutral)	51.54%	39.55%
Sell (Underperform)	3.85%	50.00%

For disclosure purposes only (NYSE and FINRA ratings distribution requirements), our Buy, Neutral and Underperform ratings are displayed as Buy, Hold and Sell, respectively.





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