RUTGERS Student Research

Medco Health Systems (MHS): Long Term Value Play

NYSE: MHS, $58.92
Price Target: $90.00

April 30, 2008
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BUY

Market Profile (4/30/10)	
Stock Price	$58.92
52 week range	$66.94-$42.46
Beta	0.45
Shares Outstanding	478.2
Market Cap	$26.9B
Enterprise Value	$29.4
Institutional Holdings	80.4%
Insider Holdings	0%
Short % of Float	2%
Book Value per Share	12.09
Debt to Equity (12/09)	72.74
Return On Equity(12/09)	22.6

Investment Summary

Maintaining BUY rating over the next 12 months, MHS is well positioned to outperform the market and its peers in the PBM sector. The decision is based on a view of the company's long term outlook and sustained ability to generate free cash flow, to invest that cash flow, and grow its revenues and profitability. Layering our valuation onto a global macroeconomic backdrop, our belief is that Medco is best positioned to benefit in the next 5 years from the wave of patent expirations expected to hit the market and the expansion of healthcare to an additional 19 million members through the Health Care reform as well as the longer term impact of the aging of Americans.

- **The pharmacy benefit management (PBM) industry is experiencing favorable trends.** National drug expenditures are expected to more than double over the next 10 years, generic launches and penetration rates will hit unprecedented highs and health reform is expected to provide drug coverage to millions of the uninsured. Additionally, the population is aging and treatment of chronic illness is increasing. The convergence of these factors is positive for an industry that recognizes much of its growth though increasing volume and benefits from additional scale within the drug supply chain.

- **Tsunami of generics on the way**. We estimate that 2011 and 2012 will be record years for generic entries. Additionally, these generic launches have higher mail order penetrations than historical comparision. This will favorably impact growth, cost, and profitability .

- **Medco growth continues.** The company continues to secure new customers (more than $4 billion in new contracts signed for 2010), maintain existing business (99% of renewal rate in 2010), and establish new seeds for growth (e.g., international) while retaining flexibility for its use of cash.

- **New business segments will drive future growth and further establish MHS as the premier PBM**. Medco is going global through partnership and acquisitions of international companies. They are also making significant investments and R&D commitments into personalized medicine. Being the leader in new markets should further advance their reputation as the partner of choice for PBM services and expand their business model and product offerings to new customers.

- **Strong cash position**: Medco reported more than $2.5 billion of cash as of 4Q09 and projects operating cash flows over $2 billion next year. The company remains the most logical suitor of attractive and available acquisition assets as a way to increase revenues, in our view.

- **Valuation.** We believe that Medco's positive momentum and potential to exceed near-term expectations and continue to expand its business segments is favorable. We believe there is room for significant growth in the stock and rate this stock a BUY. Our valuation analysis suggests the stock's intrinsic value is actually 35% higher than its current stock price based on our revenue growth forecasts, analysis of DCF, forward PE, forward EBITA/script, Price/FCF multiples.

- **Risks:** Risk to our price target is that competition will erode generics profitability; UNH (MHS's largest customer) could change or end its contract with MHS (term end 2012); and healthcare reform could adversely affect PBMs through added taxes

Company Background

Medco Health Systems (MHS) is the US's largest independent pharmacy benefit manager (PBM) serving the needs of more than 65 million people. Basic services for all PBMs include establishing a network of pharmacies (i.e., chain store, community based, mail order service) for beneficiaries so they can obtain prescribed outpatient drugs. The PBM negotiates the price paid with network pharmacies (i.e., discount from AWP plus dispensing fee) and processes claims on behalf of the payer.

Medco Health Solutions, Inc., is a pharmacy benefit manager (PBM) based in Franklin Lakes, New Jersey, The company employs approximately 22,000 people nationwide, including 2,650 pharmacists and 650 nurses. Its customers are private and public employers, health plans, labor unions, and government agencies of all sizes, and individuals served by Medicare Part D Prescription Drug Plans. The company business model was built on a foundation of effective management of prescription drug trends. MHS offers clinically driven pharmacy services designed to improve the quality of care and lower total health care costs for its customers; historically through use of generic medications, formulary management, therapeutic substitutions, and mail order delivery of prescriptions.

Martin Wygod was the visionary who created Medco Containment Services through the acquisition and consolidation of a mail order prescription firm, National Pharmacies and a claims-processing company called Paid Prescriptions in the mid 80s. Wygod grew MHS throughout the late 1980s and early 1990s through additional acquisitions and aggressive marketing to big corporations and labor unions. In addition to its claims processing business, MHS was marketing mail order pharmacy as a new concept to its customers and potential customers and by 1993 MHS accounted for over one-half of the U.S.'s mail-order drug business and had over 1,300 customers, including General Electric, Mobil, and General Motors. With that kind of presence and scale, MHS caught the attention of large pharmaceutical companies. As a result, on July 28, 1993, Merck & Co. announced that they would acquire MHS for $6 Billion and formed Merck-Medco. There were a number of consolidations as many other big pharmaceutical companies acquired and aligned with claims processing organizations during the early 1990s; however, many of these combinations were dissolved and by 2000, Merck-Medco was the only Pharma-PBM marriage that had survived.

Medco was listed on the NYSE on August 19, 2003, in the largest domestic corporate spin-off of that year when Merck & Co distributed all of the outstanding common stock of Medco Health Solutions to Merck shareholders of record. In its first full year as an independent company MHS generated revenues of $37.6 billion, up 6.5% over 2003. Approximately two years after its IPO, MHS significantly expanded its specialty business with its acquisition of Accredo Healthcare in August of 2005 which added many higher margin, niche specialty products to MHS' product offering and has helped to position the company to more competitively bid for specialty business. On August 28, 2007, Medco announced that it was acquiring PolyMedica for $1.5 billion in cash, or $53 per share. This acquisition is a logical effort to further broaden the company's delivery platform, highlighting the importance of servicing the diabetic population, which is a heavy user of medical supplies and medications.

MHS has also been expanding internationally and in March 2008, Medco launched a collaboration with Sweden's government-operated retail pharmacy authority, Apotheek, to develop and test the first automated electronic prescription review system to improve clinical and financial outcomes for Swedish patients and the country's healthcare system. Medco also acquired a majority stake in Europa Apotheek (for $120 million) in April 2008 to tap the fast-growing German pharmacy healthcare services market. Finally, in 2009 Medco entered into a joint venture with United Drug in 2009, a European healthcare organization, to provide home-based pharmacy services in the U.K. The joint venture will offer services to the National Health Service (NHS) and its close to 60 million beneficiaries. Medco emphasizes that homecare pharmacy services represent $1.6 billion in annual drug spending in the U.K.

MHS most recent acquisition of DNA Direct is in the area of personalized medicine and provides an additional expansion opportunity. The DNA Direct purchase builds upon Medco's commitment to advancing pharmacogenomics.

Pharmacy Benefit Management Industry Overview and Company Peer Descriptions

A small group of independent PBMs dominate the market. The PBM industry has experienced significant consolidation over recent years as organizations have sought scale within the drug delivery chain. The industry is dominated today by a group of large organizations that are primarily independent PBMs and the top 3 providers process roughly 50% of prescriptions. The PBM industry is critical to the provision of healthcare benefits in this country and we believe that the demographic trends in the US as well as the increased focus on managing chronic illness within a cost-conscious environment will elevate PBMs usefulness in the future and we are therefore positive on the PBM sector as a whole.

While all retail networks are similar for PBMs, mail order services provide a potential for differentiation and a source of savings for health plans and a source of greater profits for PBMs. Mail order is very convenient for chronic conditions and usually allows for a 90 day dispensing supply versus the 30 day retail days supply. Given the greater cost savings PBMs can generate from mail order services, we believe that they will continue to create incentives to drive patients with chronic conditions toward mail order. Additionally, our independent research conducted through a survey with 20 current plan participants in Medco's PBM at a major US corporation, shows a willingness to switch to mail order for chronic medications and a high degree of satisfaction among those patients who have switched their dispensing from traditional retail pharmacy channels to mail order channels.

Mail order penetration rates for the 3 largest PBMs have been increasing over the last few years; from 25% to 35%; however, growth in penetration slowed in 2009. Our primary market research with current Medco plan participants demonstrates they are more willing to utilize mail order and we believe there will be an acceleration in utilization of mail order in the next 3 years based on the lower cost incentives for using mail order, increased use of e-prescribing or electronic faxing of prescriptions, and an increasing patient pool who are comfortable using technology to order and have less patience and time to wait for a prescription to be filled at a pharmacy. We are projecting that by 2015 a 60% increase in the utilization of mail order for Medco services based on our survey responses.

The largest PBMs also offer specialty drug management as a service and this segment provides a significant source of revenue. Specialty pharmaceuticals are primarily biological pharmaceuticals and tend to be significantly more expensive than traditional drugs. Moving forward, there will be more drugs becoming approved in this classification and the generics biologics pathway may provide the catalyst for growth beyond 2015 when many of the blockbusters biotechnology drugs go off patent.

Table 1: Comparison of Independent PBMs and Health Plans with PBM

Company Comparison						
Medco Health Solutions Inc						
Industry Comparison						
Valuation Ratios	**MHS**	**ESRX**	**CVS**	**SXCI**	**CHSI**	**UNH**
P/E	22.46	32.25	14.54	40.79	29.85	9.04
Beta	0.45	0.92	0.74	1.06	0.84	0.98
Price/Rev	0.45	0.93	0.52	1.45	0.68	0.41
Price/Bk Val (Quarter)	5.02	7.73	1.45	4.54	4.43	1.49
Price/CF TTM	15.49	27.73	10.15	33.82	25.46	7.12
Price/FCF TTM	11.63	13.58	49.36	26.92	19.31	7.15
% Owned Institutions:	80.42	91.34	83.04	83.11	82.37	85.99
Growth Rates (%)	**MHS**	**ESRX**	**CVS**	**SXCI**	**CHSI**	**UNH**
Revenue, %Yr/Yr (Quarter)	9.96	105.5	6.96	51.42	8.8	5.4
Revenue - 5 Yr. Growth Rate:	11.09	3.79	26.4	112.7	40.89	17.92
EPS, %Yr/Yr (Quarter)	15.43	8.72	14.57	142.31	24.83	26.69
EPS - 5 Yr. Growth Rate:	24.41	28.19	18.39	72.15	26.94	12.09
Capex, 5 Yr.Avg:	19.47	23.73	13.59	43.97	1.61	15.73
Financial Strength (1Q10)	**MHS**	**ESRX**	**CVS**	**SXCI**	**CHSI**	**UNH**
Quick Ratio	0.95	0.72	0.58	2.47	1.3	0.8
Curr Ratio	1.16	0.78	1.43	2.51	1.31	0.8
LT Debt/Tot Eqty	72.35	68.35	24.48	0	0	32.9
Tot Debt/Tot Eqty	72.74	100.16	31.24	0	0	43.27
EBIT Interest Cover, LFY:	14.41	7.46	12.26	15.79	--	12.31
Profitability Ratios (%)	**MHS**	**ESRX**	**CVS**	**SXCI**	**CHSI**	**UNH**
Gross Profit % Margin (Quarter)	6.09	8.41	20.64	11.85	6.76	22.79
Gross Profit % Margin, 5 Yr. Avg.:	6.38	7.93	22.2	17.2	6.49	23.78
EBITDA % Margin (TTM)	4.55	5.72	7.93	6.18	4.03	8.73
EBITDA % Margin, 5 Yr. Avg.:	4.25	5.25	7.81	7.05	3.87	9.79
Oper Income % Margin (Quarter)	3.51	5.24	6.52	5.1	3.62	7.59
Oper Income % Margin, 5 Yr. Avg:	3.12	4.74	6.33	5.2	3.45	8.72
Income Tax % Rate, 5 Yr. Avg.:	38.5	36.12	38.41	26.09	37.59	35.76

Source: Reuters

Major PBM Player Descriptions:

- Express Scripts, Inc.(ESRX) provides a range of typical PBM services in North America. It serves HMOs, health insurers, third-party administrators, employers, union-sponsored benefit plans, workers' compensation plans, and government health programs. On December 1, 2009, Express Scripts announced the close of the acquisition of WellPoint's PBM subsidiary, NextRx for $4.7B. We view this acquisition very positively. ESRX has stated it expects this acquisition to add over $1B in EBITDA after integration. The transaction include long term (10 year) PBM service contracts which further ensures ESRX as a major player in the PBM space in the future and allows for good cost saving opportunities with a consolidated facilities, and better drug buying scale. We do believe that in the near term there is some integration risk for a deal of this size. ESRX is experienced at integrating companies through acquisition; however, this deal is significantly larger than any other deal completed to date. We feel ESRX may be underestimating the effort required to realize the cost synergies in the next 12-18 months. 1Q10 profitability metrics like EBITDA per adjusted script and the quarterly EBIT margin came in below analyst projections. This may represent opportunities for other PBMs to capitalize on ESRX potential distraction from its legacy customers.

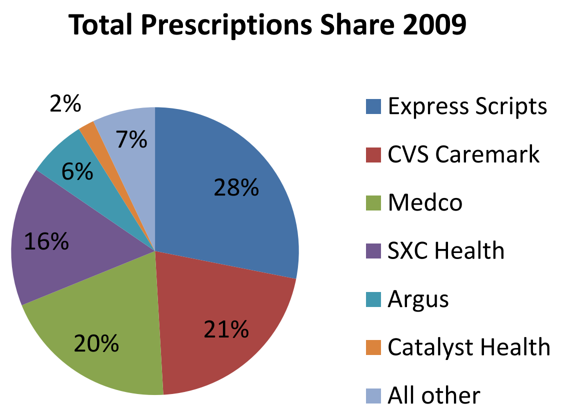
- CVS Caremark Corporation operates in two segments, Pharmacy Services and Retail Pharmacy. The Pharmacy Service segment provides a range of prescription benefit management services, including mail order pharmacy services, specialty pharmacy services, plan design and administration, formulary management, and claims processing. This segment primarily serves employers, insurance companies, unions, government employee groups, managed care organizations and other sponsors of health benefit plans, and individuals. As of December 31, 2009, it operated 49 retail specialty pharmacy stores, 18 specialty mail order pharmacies, and 6 mail service. The Retail Pharmacy segment operated 7,025 retail drugstores located in 41 states and the District of Columbia; and 569 retail health care clinics in 25 states. We feel CVS Caremark has been least able to compete with the large PBM, historically. The drugstore side is 60% of earnings and we feel the PBM component of this dual focused company is not as competitive as MHS and ESRX. CVS lost some key customers to MHS in the last 6 months; however, new management is now in place and the company may see a renewed focus and ability to create more value.

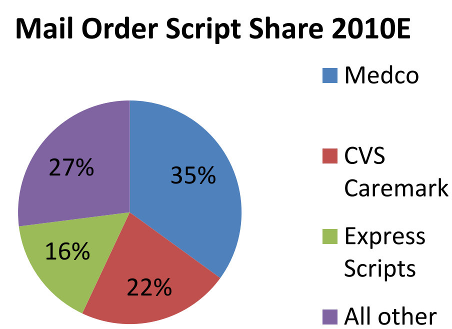
- SXC Health Solutions Corp. is a leading provider of PBM services and Healthcare Information Technology ("HCIT") solutions to the healthcare benefits management industry. As the industry's "Technology-Enabled PBM"™, SXC's product offerings and solutions combine a wide range of advanced PBM services, software applications, application service provider processing services, and professional services to help healthcare organizations reduce the cost of prescription drugs and deliver better healthcare to their members. SXC serves many of the largest organizations in the pharmaceutical supply chain, such as health plans; employers; federal, provincial, and state governments; institutional pharmacies; pharmacy benefit managers; and retail pharmacy chains. SXC is currently trading at a higher multiple to other PBMs. We feel HCIT initiatives are a natural fit with PBMs. This company, although a small player today, is the fastest growing company in the PBM universe, and continues to be at an early stage of its corporate life cycle relative to other large public PBMs. It could represent an interesting takeover target for one of the larger PBM (MHS) but we do not feel it has the scale or cash flows to compete for the same level of customer contracts as ESRX and MHS.

- Catalyst Health Solutions, Inc., together with its subsidiaries, operates as a classic PBM in the United States and operates under the Catalyst Rx brand name. The company provides its clients access to a contracted national network of approximately 63,000 pharmacies and serves self-insured employers, including state and local governments; managed care organizations; third-party administrators; unions; and individuals. The company was formerly known as HealthExtras, Inc. and changed its name to Catalyst Health Solutions, Inc. in October 2008.

- Additionally, many of the managed care organizations operate their own PBMs. United Health represents the largest of these health plan PBMs and had approximately 300MM prescriptions filled in 2009. These organizations will not be analysed in detail here as their business models are different.

Figure 1:Independent RX Market Share for Select Companies and Mail Order





Source: Atlantic Information Services and Stifel Nicolaus estimates

Investment Thesis:

Overall the Trends Effecting the PBM Space are Positive: The changing landscapes of the health insurance industry in our opinion results in PBMs being best positioned to reduce cost and maximize the utilization of outpatient prescription drugs over the near to mid-term horizon and provide for stable and growing generation of cash flows.

- **Demographics of the US population**: The Centers for Medicare and Medicaid Services (CMS) projects that national drug expenditures will more than double between 2007 and 2018 to $454 billion. It is a clear that PBMs will continue to benefit from increased drug utilization and spending. Increasing treatment and management of chronic illness and overall volume will provide for future growth beyond what has currently been seen. Baby Boomers are aging and represent a large pool of patients for PBMs. Baby boomers are generally more educated than generations that came before them and expect to live well past retirement. They demand a certain level of service from their healthcare plans and PBMs. They are more technology savvy and are comfortable on the internet which should drive mail order higher in the years to come.

- **Increased generic drug and mail order penetration**. Generic drugs currently represent over 60% of drugs dispensed and this penetration should rise well above 70% in the next several years before brand patent expirations slow in 2013. PBMs maximize earnings by shifting customers to generics, primarily in the mail order setting where the companies physically handle the drugs. Table 2 illustrates the branded drugs with greater than $1B in sales that will come off patent in 2010 – 2014 along with sales data and estimated 4Q09 mail order penetration. The amount of sales for blockbuster drugs that will lose patent exclusivity is unprecedented. These drugs also have higher mail order penetration rates than historical brand to generic switches. PBMs and health plans are becoming increasingly adapt at maximizing the switch from Brands to generics and this will drive increased profitability for PBM in the next 3-5 years.

Table 2: Branded Drugs with > $1B Sales Losing Patent Protection

Branded Product	Expiration	Total Sales	Estimated Mail Penetration (RXs)
Effexor XR	July 2010	$2.9B	23%
Cozaar/Hyzaar	April 2010	$1.5B	35%
Aricept	November 2010	$1.9B	23%
Flomax	April 2010	$1.6B	35%
Lipitor	November 2011	$8.0B	39%
Actos	August 2011	$2.3B	32%
Zyprexa	November 2011	$2.6B	10%
Levaquin	April 2011	$1.5B	0.7%
Plavix	May 2012	$4.8B	29%
Seroquel	April 2012	$3.9B	9%
Singular	September 2012	$3.4B	22%
Diovan & Combos	September 2012	$3.0B	33%
Lexapro	March 2012	$2.7B	21%
Tricor	August 2012	$1.5B	37%
Aciphex	May 2013	$1.2B	26%
Crestor	July 2013	$2.1B	38%
Cymbalta	June 2013	$2.4B	19%
Oxycontin	April 2013	$2.3B	0.2%
Celebrex	May 2013	$1.9B	37%
Nexium	November 2014	$5.4B	39%
Humalog	June 2014	$1.2B	29%
Vytorin	March 2014	$1.9B	43%
Copaxone	May 2014	$1.4B	21%

Source: Orange Book analysis; IMS sales figures; Evaluate Pharma; company filings
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- **Health reform is an opportunity**. PBMs are in a position to benefit from insurance coverage to the nation's 47 million uninsured through expansion of national coverage. These currently uninsured patients are all new customers that will be added to new or existing plans. Emphasis today is on providing cost effective which will drive patients toward appropriate use of generic medications.

- **Expanding the value proposition and provided customer driven solutions**. Leading drug benefit managers continue to expand services to customers including behavioral economics, disease management, and broader attempts to integrate pharmacy and medical data to better manage overall medical care. Expansion of services will support future growth, in our view and reductions in inappropriate use of drugs in patients that are not likely to benefit and increased utilization of lower cost alternative.

Investment Thesis for MHS Versus Peers in the PBM space

The Goliath of PBMs and Mail Order:
Medco has the largest and most advanced, integrated infrastructure in the marketplace. Their size and competitive advantages driven by their scale and ability to create cost advantages for their customers allowed them to win $10B in new business in 2009 and over $4B in 2010 already. Its size relative to its peers is not to be trivialized and will be leveraged even more competitively as more patients are added to plans through health reform and through the favorable demographic trends expected in the future.

We believe that MHS' profitability is dependent on its ability to drive generic drugs through its mail pharmacy. Generic scripts processed through the mail channel are 5-10x more profitable than brand drugs dispensed through the retail channel, according to the Federal Trade Commission (FTC). This could have important positive profit implications for MHS in 2010 through 2012; above and beyond the peer group; given the size and number of blockbuster products expected to go generic over the next few years with high mail order penetrations. Over the past six years, the company has seen its overall generic mix increase from 46% of total RXs to some 69%. In the same six year period, its generic mix as a percentage of retail scripts has increased from 48% to 69% and has increased from 38% to 58% as a percentage of mail scripts. This product mix shift could have important profit implications for MHS particularly if it is successful converting some of these retail scripts to mail. The infrastructure, automation and mail order leadership MHS has cannot be easily duplicated and provides an economic moat and sustainable and competitive advantage for the company as compared to its peers.

We administered a written anonymous survey of 20 corporate employees with Medco PBM prescription drug plans. These employees recently had their coverage switched from a HMO PBM. The incentives to have chronic prescriptions filled through mail order were perceived to be significant with over 60% of those with chronic conditions treated with prescription medications saying that they have switched to mail order for their chronic prescription needs in the last year. Our findings suggest that the lower co-pay is the number one driver of a patients choice to use mail order (60%). The convenience of not having to physically go to the pharmacy was also cited fairly high (50%). The survey document used in this research can be found in appendix A.

Medco's New Business Wins and Strong Client Retention Rate Should Drive 2010/11 Earnings Growth:
In 2009, Medco won $10B (net new over $8B). In addition, the company's retention rate of 99% is very high. Importantly, the mail penetration rate of MHS' new wins is low, around 9%, which is well below the company's overall historic average. We view the high retail rate on new business as a positive, since it gives MHS greater opportunity to convert the volume to mail. Our independent research suggests that new Medco clients are willing to switch to mail order to a great degree.

Specialty drugs have become very important to the pharmaceutical industry as a source of profits and will become more important to PBMs as well. Medco's specialty pharmacy presence through Accredo has helped to allow for additional margin expansion. Accredo, acquired by MHS in mid-2005, is a leading specialty provider that specializes in high cost, niche drugs used to treat chronic conditions. Payors are increasingly looking for a single provider of PBM and specialty pharmacy services. We believe that the acquisition of Accredo has allowed MHS to more effectively compete for this type of business. The combined company has access to nearly all of the specialty products of its closest competitors allowing MHS to pitch itself as a full service provider. It was noted at the company's November Analyst Day that there is still nearly 20% of Medco's membership base that is not utilizing Accredo's specialty services, and we certainly view this to be a significant opportunity over the next few years.

New Services and Future Market Shaping:
Medco continues to innovate and advance personalized medicine and a way to differentiate itself in the market. Medco's Chairman and CEO, David Snow, has stated that the idea of "trial and error" medicine is very costly, with an estimated $17-plus billion of "wasted" dollars spent on key conditions where there only a modest response to medication. This might be just talk if not for the client and patient response shown already. Over 200 clients have enrolled for pharmacogenomic clinical programs representing approximately 7 million lives.

Medco has taken a leadership role and announced the recent launch of the largest pharmacogenomic comparative effective study ever. The study, nicknamed GeCCO, aims to determine whether the effectiveness of Plavix is similar to Effient based on a patient's genetic makeup. Medco is positioning itself to drive decision-making around use and differentiation, to benefit its client value in multiple drug spending categories.

Personalized medicine has been discussed for years since the Human Genome project in the 90s however little clinical application has been seen. MHS is positioned to have the tools and data to drive usage of drugs based on genetic information like metabolizing profile which could have real clinical utility for patients on Warfarin, a highly potent drug, which is considered to be the No. 1 drug-related cause of death in the U.S. Given that there are three enzymes that metabolize 50%–60% of all drugs and where there are instances of frequent genetic variation, better understanding the variation in two of the three enzymes being studied can provide for an interesting database of knowledge for many medications that metabolize differently. That is a service we strongly believe will be valued by any MCO in the future and would serve as a additional source of leverage for bringing on new customers and keeping customers with MHS. The costs of drug related adverse events and hospitalization are extremely high and in many cases avoidable.

Strong Cash Position in Consolidating Industry:
MHS should continue to generate strong cash flows, which can be used for capital investments, share repurchases, and future acquisitions. The guidance provided by the company that it will generate $3 billion of cash flow in 2010 will fuel the company's future growth. While we believe MHS can grow the business organically by securing new contracts and capitalizing on the market's positive dynamics, we still believe there is a keen interest in selective augmentation of that growth through selective add-ons. It strikes us that Medco really does not face meaningful competition in bidding for certain assets given the recent ESRX acquisition of NextRx. That said, we believe that the company remains very aware of opportunities to expand its footprint in the PBM space, and intends to augment that base footprint with additional peripheral acquisitions, both domestically and internationally. Opportunities for continued consolidation and acquisition benefits, with the real potential for further scale-building should mean more product cost-reduction benefits for MHS as they are the only PBM with the cash to acquire larger scale businesses. We believe that more M&A activity will occur in 2010 and MHS will be well positioned to capitalize on this.

Financial Modeling:

Earnings Model

Income Statement										
Medco Health Solutions Inc										
Income Statement - Annual - Standardised in Millions of USD										
Fiscal Period:	2009	2010 Q1	2010Q2	2010Q3	2010Q4	2010	2011	2012	2013	2014
Total Revenue	$ 59,804	$ 16,311	$ 16,882	$ 17,473	$ 18,084	$ 68,750	$ 75,624	$ 81,674	$ 86,575	$ 90,038
Gross Margin %	6.73%	6.09%	6.09%	6.03%	5.97%	5.91%	5.85%	5.79%	5.73%	5.67%
Depreciation/Amortization	$ 306	$ 71	$ 73	$ 75	$ 77	$ 295	$ 310	$ 322	$ 332	$ 338
Total Operating Expense	$ 57,701	$ 15,779	$ 16,252	$ 16,740	$ 17,242	$ 66,012	$ 72,283	$ 77,487	$ 81,672	$ 84,612
Operating Margin	3.5%	3.3%	3.7%	4.2%	4.7%	4.0%	4.4%	5.1%	5.7%	6.0%
Operating Income	$ 2,103	$ 532	$ 630	$ 733	$ 842	$ 2,738	$ 3,342	$ 4,187	$ 4,903	$ 5,426
Provision for Income Taxes	$ 823	$ 212	$ 246	$ 286	$ 329	$ 1,068	$ 1,303	$ 1,633	$ 1,912	$ 2,116
Net Income After Taxes	$ 1,280	$ 321	$ 384	$ 447	$ 514	$ 1,670	$ 2,038	$ 2,554	$ 2,991	$ 3,310
Diluted Weighted Average Shares	490	478	478	478	478	478	478	478	478	478
Diluted EPS	$ 2.61	$ 0.67	$ 0.80	$ 0.94	$ 1.07	$ 3.49	$ 4.26	$ 5.34	$ 6.25	$ 6.92
Effective Tax Rate	39%	39%	39%	39%	39%	39%	39%	39%	39%	39%

DCF Model:

Cash Flows and DCF Model	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
MHS Operating Income (From Earnings Model)	$ 2,738	$ 3,342	$ 4,187	$ 4,903	$ 5,426	$ 5,912	$ 6,351	$ 6,734	$ 7,052	$ 7,298	$ 7,466
Tax Rate	39%	39%	39%	39%	39%	39%	39%	39%	39%	39%	39%
Add Depreciation	$ 295	$ 310	$ 322	$ 332	$ 338	$ 344	$ 349	$ 354	$ 357	$ 360	$ 362
MHS Free Cash Flow After Taxes (Millions)	$ 1,850	$ 2,227	$ 2,751	$ 3,193	$ 3,516	$ 3,816	$ 4,088	$ 4,324	$ 4,520	$ 4,671	$ 4,775

Sensitivity		Implied Value/ Share
NPV of Cash Flows including terminal value (WACC 8%)	$ 57,987	$118.34
NPV of Cash Flows including terminal value (WACC 9%)	$ 54,273	$110.76
NPV of Cash Flows including terminal value (WACC 10%)	$ 47,246	$96.42
NPV of Cash Flows including terminal value (WACC 11%)	$ 41,800	$85.31
NPV of Cash Flows including terminal value (WACC 12%)	$ 37,460	$76.45
Outstanding Shares / Fully Diluted	490	

Terminal Value
1%

Recommendation and Price Target

Medco share are currently trading at 22x the 2009 EPS of $2.61. We continue to like Medco's ability to further raise the bar on cash flow generation. A five year historical PEs suggest that MHS trades between 20 and 22X forward earnings. Given our earnings model and a EPS of 4.26 in 2011, this would suggest MHS should be trading at $85.00.

Due to our long term outlook for the company and positive expectations regarding the ability for this company to consistently deliver on the positive free cash flow generation story, we believe DCF represents the best model for valuing the company's intrinsic value. Based on our analysis, the shares are significantly undervalued. We currently believe that operating income will double as a result of increasing the patient pool for PBMs in the next five years. While we have allowed for a modest decline in gross margins due to an expectation that new business and renewals and increased volume will come under pricing pressures, we feel MHS will be able to leverage their huge infrastructure as they bring on new customers and this ability to leverage represents a sustainable competitive advantage. As RX volume increases due to demographics and new patients entering the system due to healthcare reform, MHS will be best positioned to drive operating income growth by providing value added services like personalized medicine profiling and driving business to their more profitable mail order pharmacy.

Based on the analysis we have completed and our belief that MHS represents a stock with a economic moats that ensure it will be operating and providing meaningful services 10 years from now, I believe that MHS stock at today's current price ($58.92) provides investors with a value investing BUY based on its intrinsic value of between $90.00 and $110.00 dollars per share. The stock is currently trading at 35% below my low range for intrinsic value. My price target for this company is $90

Investment Risks

- **Price Pressure** from combinations in the industry could cause more aggressive pricing discounting to be introduced customers and a shift toward more transparent pricing.
- There could be a continued **customer shift** away from providing drug coverage for retirees given potential tax changes
- **Renewal Risks** for contracts up for renewal in 2010 and increase pressure on margins.
- **Healthcare Reform** could reignite the debate about a potential tax being placed on the PBM industry
- **Rising unemployment rates** in the U.S. or a continued recession could have some impact on covered lives and consequentially utilization, in our view.
- **Competition from low cost 7$ generic prescriptions from retail giants** like Walgreens. It will be difficult for Medco to drive these patients to Mail.

<u>Appendix A:</u>

<u>Survey Document Provided to Corporate Employees who Recently Switched to Medco PBM</u>

Can you please fill out this short anonymous survey and place it in the provided envelope. You will be helping one of your fellow employees complete her MBA and better understand the current utilization of and attitudes toward mail order pharmacy and the potential impact of e-prescribing on mail order pharmacy.

1. Do you currently subscribe to health insurance coverage through your employer? (Check one)
   ___________Yes __________No

2. Do you or anyone in your family (dependents) currently take any prescription medications chronically? (Check one)
   ___________Yes __________No

3. How do you or anyone in your family (dependents) **currently** obtain your chronic prescription Medications? Check all that apply
   _______Pharmacy Chain
   _______Pharmacy Supermarket
   _______Pharmacy Independent
   _______Mail order delivery
   _______Other_________________________________ Describe

4. Have you anyone in your family (dependents) ever used mail order delivery to obtain any prescriptions in the past?(Check one)
   ___________Yes __________No

5. In the past year have you anyone in your family (dependents) changed how they obtain chronic medications? ___________Yes ___________No How have you changed and why?

6. How likely are you anyone in your family (dependents) to use mail order in the future if you require chronic prescription medicine on a scale from 1-5; where 5 is very likely and 1 is not very likely at all? (circle one)

   1 2 3 4 5

7. What is most likely to convince you anyone in your family (dependents) to use Mail Order for your prescription needs:(Circle the 2 that you feel are most influential on your decision)
   a. Lower co-pay
   b. Obtaining an extended supply of your medication
   c. Convenience of not having to go to pharmacy
   d. Doctor prescribing electronically
   e. Other: ____describe

8. Demographics
   a. Sex: ____ M ______F
   b. Age _______

Appendix B: Financial Statements Provided in Hard Copy

A. Income Statement
B. Balance Sheet
C. Cash Flows