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WEALTH

Fortune favours the brave

Viewing the eruption of Mount Vesuvius from his ship in the Gulf of Naples, Pliny the Elder declared that "Fortune favours the brave" and set a course to rescue his friends from Stabiae, near Pompeii. Needless to say, Fortune did not favour him. Nevertheless, his maxim has become a byword for seizing opportunity whenever it presents itself. McKesson is one such opportunity: having suffered at the hands of an over-zealous market, the stock now trades at a sizeable discount.

As the largest pharmaceutical procurement and distribution company in the US, McKesson delivers roughly a third of all prescription medications across North America. Thanks to its status as the dominant triarch in a highly consolidated industry (where the triarchy comprises over 90% of the market), the company benefits from a near unassailable moat. Economies of scale are significant, allowing McKesson and its peers to secure better payment terms with suppliers and enjoy volume discounts. To deter would-be competitors, however, margins are very thin.

The recent concerns surrounding McKesson stem partly from customer concentration. For instance, in 2015 sales to McKesson's largest customer accounted for almost 15% of consolidated revenue while, together, the top ten accounted for 44%. Given this, it comes as no surprise that the market baulked at the news that one of McKesson's major contracts will likely go un-renewed due to an acquisition by Walgreen (who have an existing contract with a competitor). Though these numbers may seem large, they obscure the finer detail: smaller contracts are considerably more profitable. Research by Morningstar estimated that while McKesson's five largest contracts comprise 32% of sales, they contributed only 6% of operating profit. Though the loss of any contract is of course detrimental, we believe such fears are overblown.

A further cause for concern was McKesson's updated guidance citing lower than expected generic drug inflation. As McKesson updates the "cost price" of existing inventory in line with inflation, inflation is beneficial to profit margins. Accordingly, concerns over weakening inflation in the short-term are justified. While we are cognisant of the risks such short-term weakness poses, on a longer-term view we expect mid-single digit inflation to remain. Moreover, outright price deflation would not lead to negative cash flow since the company, in line with industry practice, would be reimbursed by manufacturers on the downside.

Though the firm has faced recent headwinds related to contract loss and mis-estimation of generic inflation, we believe these troubles to be overblown and shall prove transitory. Yet given the sell-off these concerns have caused, the stock now trades at a material discount which makes its current valuation an attractive opportunity for exposure to a high-quality healthcare name. Unlike Pliny the Elder, we step not into the shadow of the volcano, but rather a sector subject to substantial secular tailwinds.

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