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Fixed Income Analysis

# CVS HEALTH CORPORATION

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## Company Overview

| | |
|---|---|
| Industry: | Health Care |
| Bond Name | CVS 4.30% 2028 |
| Credit Rating (Moody)/Outlook | Baa2 |
| Maturity | March 31st, 2028 |
| Issue Size | US$5.00 Bn |
| Rank | Senior Unsecured |
| Current Price (June 9, 2023) | US$97.09 |
| Yield to Maturity (Ask) | 4.978% |
| Yield to Worst (at maturity) | 4.978% |
| Recommendation | **MARKETWEIGHT** |

CVS Health Corporation is a leading health solutions company with more than 9,000 retail locations, more than 1,100 walk-in medical clinics, a leading pharmacy benefits manager with over 110 million plan members with expanding speciality pharmacy solutions and a dedicated senior pharmacy care business serving more than one million patients per year.

Founded in 1963, the company is headquartered in Woonsocket, Rhode Island, and now serves an estimated 35 million people through traditional, voluntary, and consumer-directed health insurance products and related services. The Company believes its integrated healthcare model increases access to quality care, delivers better health outcomes and lowers overall healthcare costs.

The Company has three operating segments, Health Care Benefits, Pharmacy Services and Retail/LTC, as well as a Corporate/Other segment. As of the 2022 annual report, the Pharmacy Services segment was the largest contributor to revenue accounting for 46.0%, followed by 29.0% from the Retail/LTC segment and 24.9% from the Health Care Benefits segment.

| Financial Summary (US$ in Millions) | | | | | |
|---|---|---|---|---|---|
| | 2020 | 2021 | 2022 | Q1 2022 | Q1 2023 |
| Revenue | 268,706 | 292,111 | 322,467 | 76,826 | 85,278 |
| EBITDA | 20,967 | 20,279 | 14,511 | 4,594 | 4,447 |
| Total Assets | 230,715 | 232,999 | 228,275 | 232,873 | 239,330 |
| Total Equity | 69,701 | 75,381 | 71,315 | 74,140 | 71,580 |
| Financial Ratios | | | | | |
| EBITDA Margin (%) | 7.80% | 6.94% | 4.97% | 5.98% | 5.21% |
| Debt/EBITDA | 4.1x | 3.7x | 4.9x | | |
| Net Debt/EBITDA | 3.5x | 3.1x | 3.8x | | |

**The CVS 4.30% 2028 bond** provides investors with the ability to gain exposure to a global player in the healthcare industry. CVS has achieved significantly increased revenues and profitability in recent years and despite litigation expense and loss on asset sales, was still able to generate $4.1 billion in profits in 2022. Similarly, the company has seen growing cash generated from operations and has used that cash to make significant debt repayment resulting in total debt amounting to $70.7 billion at the end of 2022 from $89.0 billion in 2019.

Despite raising more debt in the first quarter of 2023 to fund an acquisition, CVS maintains robust credit metrics and interest coverage ratios. The operating history of the company is good, and the company has shown the capacity to service outstanding debt. It is also important to note that the Company is expected to benefit from enterprise-wide cost savings initiatives, which aim to reduce the Company's operating cost structure. Due to the non-discretionary nature of the products and services offered by CVS, the Company is likely to see continued growth in the medium term. The major risk to the company's operation are risks relating to the availability, pricing and safety profiles of prescription drugs that the company purchases and sells. **This bond is best suited for investors seeking consistent interest payments with a medium-term investment horizon and a modest risk profile.**

## Investment Rationale

- **Nature of the products and service:** The products and services offered by CVS Health Corporation are non-discretionary in nature and are therefore largely protected from economic downturns.





**Definitions:**
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UNDERWEIGHT = REDUCE EXPOSURE IN YOUR PORTFOLIO TO LESS THAN 5% FOR THIS PARTICULAR ASSET
MARKETWEIGHT/HOLD = EXPOSURE TO THE ASSET SHOULD BE EQUAL TO 5% OF YOUR TOTAL PORTFOLIO
OVERWEIGHT/BUY = EXPOSURE TO THIS ASSET SHOULD BE BETWEEN 5% AND 10% OF YOUR TOTAL PORTFOLIO

- **Strong EBITDA Generation:** For the financial year 2022, CVS reported an EBITDA of US$14.5 billion compared to that of US$20.3 billion for 2021. This is despite opioid litigation charges of 45.8 billion and a loss on assets held for sale of $2.5 billion.
- **Management Team:** The management of CVS can be described as being strong, experienced, and stable that can provide the adequate level of support and effort needed to drive operational growth and strategic initiatives.

## CVS Credit Rating

**Rating Summary:** On May 30th, 2023, Moody affirmed an assigned a '**Baa2'** rating to the new senior unsecured note issuance of CVS Healthcare Corporation ("CVS"). There are no changes to CVS's existing ratings including the '**Baa2'** senior unsecured long-term rating or the Prime-2 commercial paper rating. The outlook remains stable.

**Rating Rationale:**

CVS' rating is supported by its large scale, leading positions at its pharmacy benefit management (PBM) and retail pharmacies, and the strength of the Aetna brand in US health insurance. CVS benefits from broad industry reach and solid industry fundamentals including good store traffic, rising prescriptions and increasing doctor visits. Both the retail pharmacy and the PBM industries will benefit from demographic trends that will continue to drive the rising use of prescription drugs. Strong cash flow supports deleveraging after acquisitions.

Tempering these strengths, CVS faces execution risk as it rapidly expands its primary care business, involving the acquisitions of physician-led centres (Oak Street Health) and integrated virtual and home healthcare assets (Signify Health). Absent other large acquisitions, we anticipate lease-adjusted gross debt/EBITDA of 3.5x – 3.75x over the next 12 to 18 months which includes an adjustment for opioid liabilities. CVS faces intense competition, reimbursement rate pressure, and regulatory uncertainty, especially pertaining to drug pricing and PBM business practices.

CVS' CIS-3 indicates that ESG considerations have a limited impact on the current credit rating with the potential for greater negative impact over time. CVS' social risk considerations include exposure to responsible production and demographic and societal trends (S-4). This primarily relates to risks associated with its supply chain given the significant legal settlements involving opioids as well as exposure to regulatory efforts related to drug pricing and reimbursement rates. However, CVS' good business diversity, balanced financial policy, and experienced management team and track record mitigate these risks.

The outlook is stable, reflecting CVS' leading market position and breadth of services, as well as its good track record of deleveraging following debt-financed acquisitions.

## Industry Analysis

The healthcare industry plays a vital role in society, providing medical services, products, and technologies to promote health and well-being. It encompasses a wide range of sectors, including hospitals, clinics, pharmaceuticals, medical devices, health insurance, telemedicine, and more. The healthcare industry is one of the largest and fastest-growing sectors globally. Factors such as aging populations, increasing prevalence of chronic diseases, technological advancements, and rising healthcare spending contribute to its significant market size. According to market research, the global healthcare market is projected to reach $12 trillion by 2022, with an annual growth rate of around 5%. Technological innovations continue to revolutionize the healthcare industry, driving improvements in patient care, diagnosis, treatment, and operational efficiency. Some notable advancements include electronic health records (EHRs), telemedicine, wearable devices, artificial intelligence (AI) applications, and genomic medicine. These technologies enhance accessibility, accuracy, and personalized care while reducing costs and improving outcomes. There is a growing shift from a fee-for-service model to value-based care in the healthcare industry. Value-based care focuses on delivering high-quality, cost-effective healthcare services that prioritize patient outcomes. This transition incentivizes providers to improve care coordination, preventative measures, and patient engagement, fostering a more holistic approach to healthcare delivery.

The healthcare industry faces persistent challenges related to rising costs. Factors such as expensive medical treatments, pharmaceutical drugs, and administrative overhead contribute to the overall cost burden. Additionally, the aging population and the increasing prevalence of chronic diseases place additional strain on healthcare systems worldwide. Addressing cost containment and efficiency remains a key priority for industry stakeholders. The healthcare industry operates within a complex regulatory framework aimed at ensuring patient safety, privacy, and quality of care. Regulatory compliance requirements, such as HIPAA (Health Insurance Portability and Accountability Act) in the United States, impact healthcare providers, pharmaceutical companies, and health technology firms.

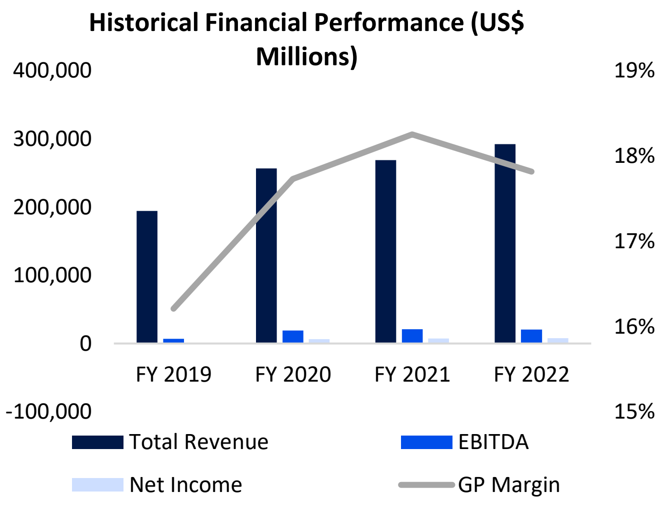
Compliance with evolving regulations poses challenges and opportunities for industry players. As digitalization expands across the healthcare industry, the protection of sensitive patient data becomes paramount. Healthcare organizations must invest in robust cybersecurity measures to safeguard electronic health records, telemedicine platforms, and interconnected medical devices. Data breaches and privacy concerns pose significant risks, necessitating the adoption of advanced security protocols and encryption techniques. The COVID-19 pandemic highlighted the need for improved health crisis preparedness and response capabilities. Governments, healthcare providers, and pharmaceutical companies are expected to invest in pandemic management infrastructure, supply chain resilience, and vaccine development. Enhanced collaboration and information-sharing between the public and private sectors are crucial to mitigating future health crises effectively. The healthcare industry is witnessing a shift towards preventive and personalized medicine, focusing on early detection, lifestyle interventions, and targeted therapies. Advancements in genomics, molecular diagnostics, and precision medicine enable tailored treatments based on individual patient characteristics, improving outcomes and reducing healthcare costs in the long-run.

The healthcare industry continues to evolve rapidly, driven by technological advancements, regulatory changes, and the growing emphasis on patient-centered care. While challenges such as rising costs and data security persist, opportunities abound in areas like digital health, personalized medicine, and value-based care. Successfully navigating this complex landscape requires collaboration, innovation, and a commitment to improving healthcare outcomes for individuals and communities worldwide.

## Financial Performance

### <u>Financial year ended December 31, 2022</u>

Total revenue for the financial year ended December 2022 (FY 2022) amounted to $292.1 billion, an increase of $30.3 billion, or 11.1% year-over-year (YoY), compared to 2021. The increase in total revenues was primarily driven by growth across all segments. The Health Care Benefits segment saw revenues increase by $9.2 billion, or 11.2% (YoY), to $91.4 billion in 2022 driven by growth in all product lines. The Pharmacy Services segment saw revenues increase by $16.2 billion, or 10.6% YoY, to $169.2 billion in 2022 and was primarily driven by increased pharmacy claims volume, growth in speciality pharmacy and brand inflation, but was partially offset by continued client price improvements. The Retail/LTC segment saw revenues increase by $6.5 billion, or 6.5% YoY, to $106.6 billion, driven by increased prescription and front store volume, including the impact of an elevated cough, cold and flu season compared to the prior year and increased sales of COVID-19 OTC test kits in 2022 compared to 2021, as



well as pharmacy drug mix and brand inflation. These increases were partially offset by decreased COVID-19 vaccinations and diagnostic testing.

Total operating cost, grew 12.8%, moving from $278.9 billion in 2021 to $314.7 billion in 2022. This was mainly driven by increases in the costs of products and benefits costs of 12.0% and 10.9% to $196.9 billion and $71.3 billion respectively. Also contributing to the increase in total operating cost was a 3.1% growth in operating expenses to $38.2 billion. The company had opioid litigation charges of 45.8 billion and a loss on assets held for sale of $2.5 billion. As total operating costs grew at a faster pace than total revenue, operating income shrunk by 41.3% YoY or $5.4 billion to $7.7 billion in FY 2022. Against this backdrop, the operating margin declined to 2.4% from 4.5% in 2021.

The Company had an interest expense of $2.3 billion, decreasing 8.6% YoY, while there was a loss of $169 million in the other income line, representing a slight improvement compared to the $182 million loss in FY 2021. This further led to $5.6 billion in income before taxes. Income tax expense decreased by 42.00% to $1.5 billion in 2022 on the back of the reduced earnings. Ultimately, net income attributable to CVS Health Corporation shareholders fell 47.5% to $4.1 billion for FY 2022.

## Cash Flows

*Cash provided by operating activities.*

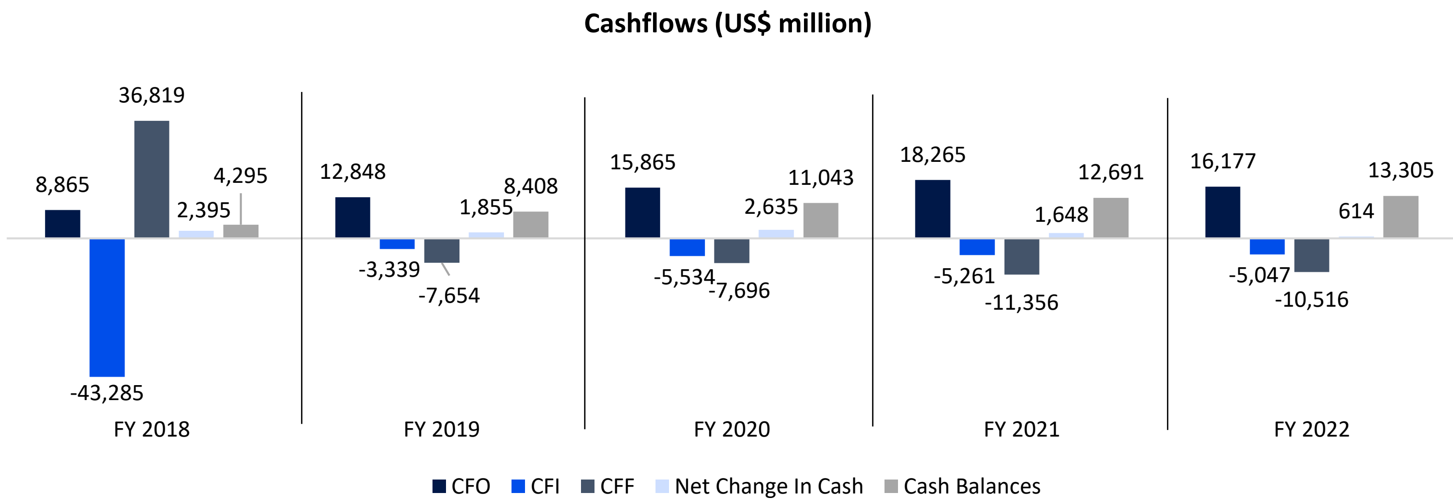
Cash flow provided by operating activities came in at $16.2 billion for FY 2022, which represented an 11.4% decrease compared to the inflow of $18.3 billion in the prior year. This decrease was primarily due to the fall in net income, coupled with a $2.1 billion outflow related to deferred taxes and a $1.4 billion net investment in inventory. However, these were partially offset by a 47.0% rise in accounts payables to $4.3 billion and a $2.6 billion inflow from the sale of assets.

*Cash used in investing activities.*

Cash flow used in investing activities was $5.0 billion in FY 2022, decreasing 4.1% compared to the prior year. Capital expenditure for the year increased by 8.2% to $2.7 billion, while purchases of investments amounted to $7.7 billion, representing a 22.2% decline. Notably, there was a cash inflow of $6.7 billion from the proceeds from investments.

*Cash used in financing activities.*

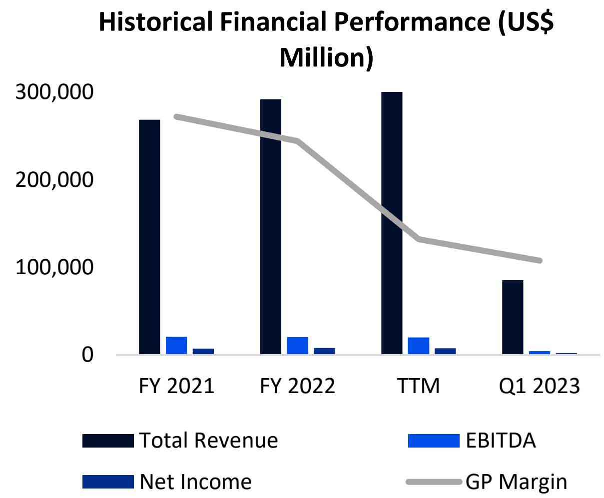
Cash flow used in by financing activities amounted to an outflow of $10.5 billion for FY 2022, decreasing by 7.4% YoY. The lower cash outflow stemmed primarily from the reduction in repayment of long-term debt, with an outflow of $4.2 billion in FY 2022, compared



to $10.3 billion in FY 2021. Additionally, in FY 2022, the Company repurchased an aggregate of 34.1 million shares of common stock for approximately $3.5 billion as part of its repurchase program. CVS also made dividend payments totalling $2.9 billion, a 10.7% increase YoY.

## Quarter ended March 31, 2023 (Q1 2023)

Total revenue amounted to $85.3 billion for the Quarter ended March 31, 2023 (Q1 2023), representing an increase of 11.0% YoY. The increase in total revenues was primarily driven by growth across all segments. The Health Care Benefits segment saw revenues increase by $ 2.8 billion, or 12.1% YoY, to $25.9 billion driven by growth in all product lines. The Pharmacy Services segment saw revenues increase by $5.0 billion, or 12.6% YoY, to $44.6 billion largely due to increased pharmacy claims volume, growth in speciality pharmacy and brand inflation, partially offset by continued pharmacy client price improvements. The Retail/LTC segment saw revenues increase $2.0 billion, or 7.8% YoY, to $27.9 billion on the back of higher prescription and front store volume, pharmacy drug mix and brand inflation.




Total operating cost, rose 11.7%, moving from $73.3 billion in Q1 2022 to $81.8 billion in Q1 2023. This was mainly driven by increases in the costs of products and benefits costs of 13.1% and 14.1% YoY to $51.5 billion and $20.4 billion respectively. Also contributing to the increase in total operating cost was a 2.7% increase in operating expenses to $38.2 billion. The Company also incurred a loss on assets held for sale of $349 million. Given that total operating costs grew faster than total revenue, operating income shrunk by 2.8% or $99 million to $3.4 billion in Q1 2023 and the operating margin declined to 4.0% from 4.6% in Q1 2022.

CVS had an interest expense of $589 million for the quarter, almost flat compared to the $586 million incurred in Q1 2022. Despite the decline in the other expenses of $22 million in Q1 2023, which was down 47% YoY, income before income tax provision decreased by 4.1% YoY to $2.9 billion. Income tax expense decreased by 14.1% YoY to $737 million, which ultimately resulted in net income attributable to shareholders of CVS Health falling 9.0% to $$2.1 billion for Q1 2023.

## Cash Flows

*Cash from Operating activities.*

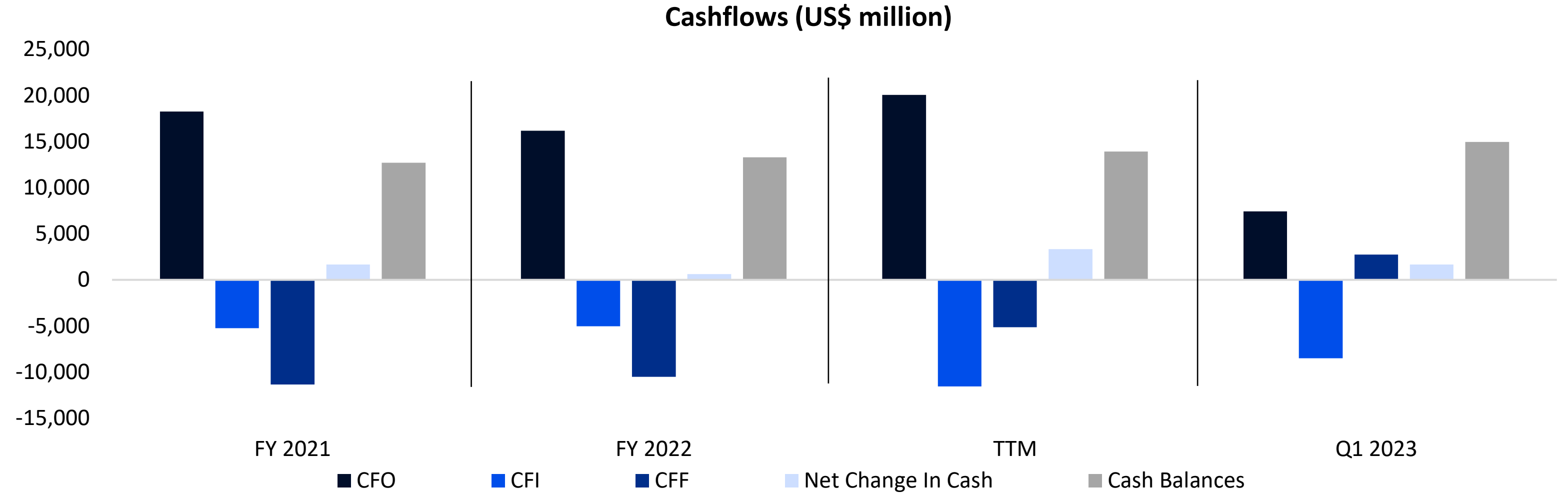
Cash flow provided by operating activities was $7.4 billion for Q1 2023, which represented a 108.8% increase compared to the inflow of $3.6 billion in Q1 2022. This increase in cash flow provided by operating activities was primarily due to an 18.3% increase in cash receipts from customers, amounting to $87.8 billion for the quarter. However, this increase in cash receipts from customers was partially offset by a 13.2% rise in cash paid for prescriptions dispensed and health services rendered to $50.2 billion and an 18.9% paid in insurance benefits paid, amounting to $19.8 billion.

*Cash used in investing activities.*

Cash flow used in investing activities totalled $8.5 billion for the quarter, which was a 327.2% increase compared to the $2.0 billion outflow during Q1 2021. Notably, acquisitions (net of cash acquired) amounted to $7.1 billion in the quarter, as a result of the acquisition of Signify Health.

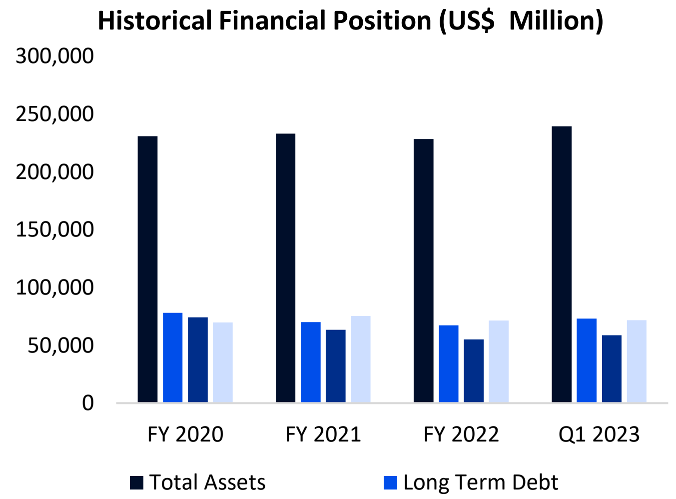
*Cash used in financing activities.*

Cash flow used in financing activities amounted to an inflow of $2.7 billion for the quarter, compared to the $2.7 billion outflow in Q1 2022. The inflow for the quarter was largely due to $6.0 billion in Proceeds from the issuance of long-term debt, which was used to fund the acquisition of Signify Health. This was offset by the $2.0 billion in stock repurchases and $779 million in dividends payments.

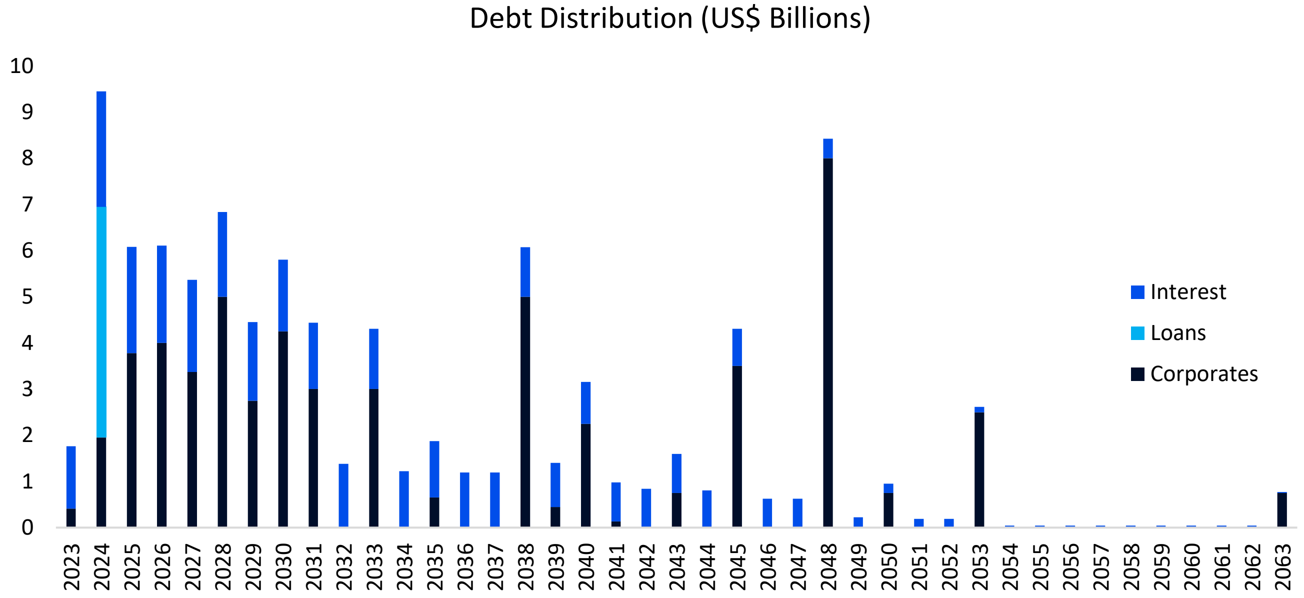



**Financial Position, Liquidity and Solvency**

At the end of March 2023, the company had total assets amounting to $239.3 billion, funded by total liabilities of US$167.8 billion and shareholder's equity of US$71.6 billion. This represents an expansion of CVS' balance sheet, with total assets increasing by 4.8% relative to the end of FY 2022 driven primarily by a 7.6% increase in goodwill as a result of the acquisition of Signify Health. The acquisition was funded by the issuance of senior secured notes which drove an 11.8% increase in long-term debt to $56.5 billion. Also contributing to the expansion of the balance sheet was a 12.9% increase in cash and equivalents to $14.6 billion and an increase in other current assets of 40.3% to $3.8 billion.




Liquidity as measured by the current ratio deteriorated marginally in Q1 2023 with an outturn of 0.92x, compared to the 2022 year-end result of 0.94x, primarily due to a 336.3% increase in other current liabilities. Additionally, the company saw a deterioration in the cash conversion cycle. CVS' days of sales outstanding stood at 31.25, compared to 30.87 days as at the end of 2022, signifying a slower conversion of credit sales to cash. The days of outstanding inventory decreased to 32.86 days from 35.39 days at the end of 2022, showing a moderate decrease in the pace of conversion of inventory to cash. The days of accounts payable outstanding moved to 22.54 days from 27.51, suggesting payables are being settled in a shorter time frame. Overall, the company's cash conversion cycle deteriorated to 41.57 days, down from 38.76 days at the end of 2022.




The company's interest coverage ratio has moved from 8.45x at the end of 2022 to 7.55x at the end of Q1 2023. Interest expenses as remained relatively constant over the years, while EBITDA has been growing and as a result, the interest coverage has been falling with the exception of FY 2022 due to some significant one-off expenses (litigation expenses and loss on asset sale). Interest expense is expected to grow because of the additional interest payable on the newly issued notes, however, the Company has demonstrated a long track record of generating sufficient income to keep interest payments manageable. As shown by the debt distribution schedule, the company has significant principal payments due in the next nine (9) years from 2023 to 2031, however, those principal payments are less than the current cash balances and the cash generated from operations. Also, the company has been able to access borrowing through the issuance of debt and has maintained good credit ratings, therefore, the Company should be able to either pay off or refinance principal payments as they become due at their discretion.

| CVS' CREDIT METRICS (US$ millions) | | | | |
|---|---|---|---|---|
| CREDIT METRICS | FY 2021 | FY 2022 | Q1 2022 | Q1 2023 |
| Total Debt | 75,999.0 | 70,732.0 | 75,915.0 | 76,478.0 |
| Short-Term Debt | 5,851.0 | 3,456.0 | 6,066.0 | 3,457.0 |
| Long Term Debt | 70,148.0 | 67,276.0 | 69,849.0 | 73,021.0 |
| Total Debt/Equity | 32.22% | 31.11% | 102.39% | 106.84% |
| Total Debt/Capital | 93.06% | 94.34% | 50.59% | 51.65% |
| Total Debt/Total Assets | 46.34% | 47.36% | 32.60% | 31.96% |
| Interest Expense | 2,503.0 | 2,287.0 | 586.0 | 589.0 |
| EBITDA to Interest Expense | 8.10 | 6.35 | 7.84 | 7.55 |

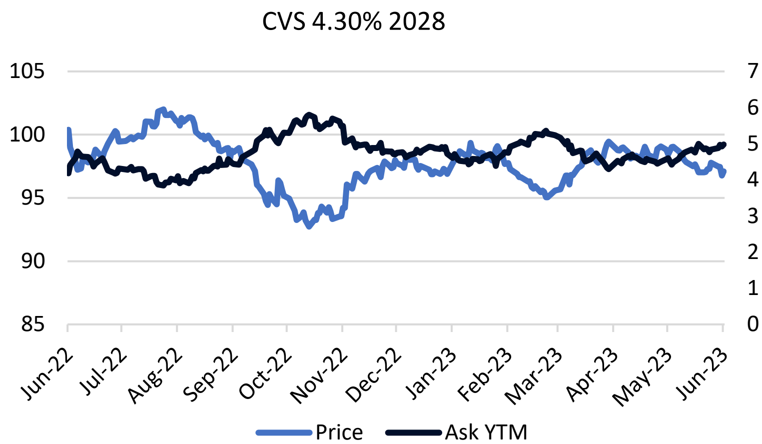
## Relative Valuation and Spread Analysis

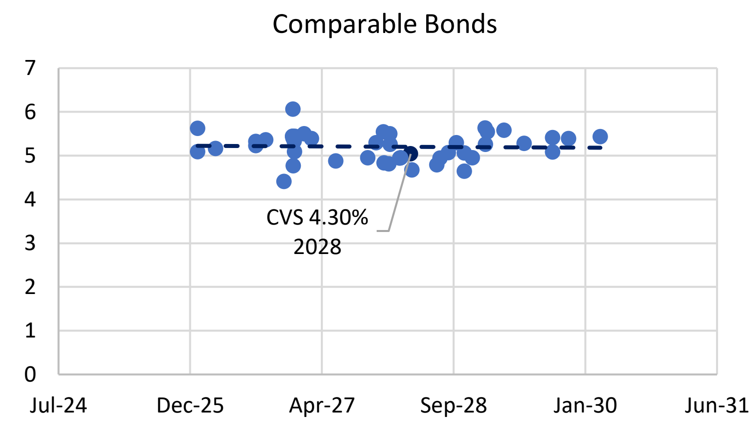
In assessing the value of a bond, its spread to certain benchmarks can be compared to historical or typical values. The spread of the bond is the difference between its yield and the yield of the benchmark. There are three main yield spreads evaluated, the G-Spread, I-Spread and Z-Spread.

The G-spread is the spread to the yield of US treasuries with similar maturity; in this case, it is the difference in yield between this bond and a US government bond with just over 4 years to maturity.

The I-Spread is the bond's spread over the benchmark USD Secured Overnight Financing Rate (SOFR) Curve. The SOFR curve has replaced the London Interbank Overnight Rate (LIBOR) as the benchmark for pricing derivatives such as swaps. A swap is an agreement where one party receives a stream of interest payments in exchange for paying a different stream of interest payments to the other.

The Z-Spread is the bond's spread over the entire US zero coupon treasury yield curve; it is the amount basis points above the treasury curve that is needed to discount the bond's future cash flows to its current market price. Generally, tighter spreads, indicate less risk as investors are pricing the bond closer to the benchmark (risk-free rates).




### CVS 4.30% 2028:

This bond is trading at a G-Spread, I-Spread and Z-spread of 111bps, 135bps and 131bps respectively. These measures are all almost identical to their 6-month average implying that there has been no contraction or expansion of the spreads to the benchmarks in that time. The lack of contraction or expansion in credit spreads between a particular bond and a benchmark indicates that the yield remains relatively stable over time and that the market views the bond as fairly priced relative to its benchmark.

| | Spread | Low | Range | High | Avg | +/- bps | StdDev | #SDs |
|---|---|---|---|---|---|---|---|---|
| 1) Spreads to Curves (RV) | | | ◆Avg ●Now | | | | | |
| 2) Spread-Bench | 114 | 98 | | 149 | 111 | 3 | 8 | 0.4 |
| 3) G-Spread | 111 | 99 | | 149 | 111 | 0 | 8 | 0.0 |
| 4) I-Spread | 135 | 121 | | 168 | 134 | 1 | 7 | 0.1 |
| 5) Z-Spread | 131 | 118 | | 165 | 131 | 0 | 7 | 0.0 |
| 6) Credit Rel Value (CRVD) | | | | | | | | |
| 7) CDS Basis | | | | | | | | |

The bond has a liquidity score of 86 (100 being the most liquid) relative to its sector which has a median liquidity score of 51. This bond has a moderate duration of 5.6 years which by extension gives investors moderate exposure to fluctuations in the bond's price as a result of changes in market interest rates. Compared to a selection of corporate bonds from other healthcare companies, the CVS 4.30% 2028 bond trades at a yield of 5.04% compared to the average of 5.30%. The spread to the benchmark of 114 bps is also narrower than the group average of 125 bps. However, this has been the trend for this bond and is likely more reflective of the fundamental strength and outlook of the Company relative to its peers rather than an overextension in pricing.

## Recommendation

The products and services offered by CVS are typically non-discretionary expenditures for their customers. This could be seen in recent years as the company was still able to grow revenue and profits even during the Covid-19 pandemic and periods of high inflation. The markets in which the Company operates remain strong and are likely to experience steady growth in the future due to demographic and other trends. The Company is expected to benefit from enterprise-wide cost savings initiatives, which aim to reduce the Company's operating cost structure in a way that improves the consumer experience and is sustainable.

However, the industry faces competition and business risks associated with the prescription drugs that the Company purchases and sells. Additionally, the Company has significant principal repayment obligations in each year from 2023 to 2029, albeit with some flexibility in how they are serviced. Considering the factors above with regard to both the fundamental prospects of the business and the market pricing of the bond, we recommend investors **MARKETWEIGHT** the CVS 4.30% 2028 bond in their portfolio, with the bond being particularly suitable for conservative investors with a medium-term investment horizon.





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