

MEDCO HEALTH SOLUTIONS (MHS)

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Sector: Health Care

as of December 19, 2008

Sell **Hold** **Buy**

AFG Value Score: 78

Target Price **\$50.93**
 Price (as of report) \$41.81
 Percent to Target 21.8%

52 week high - low \$54.63 - \$29.8
 Market Cap (m) \$20,840.3
 Shares Out. (m) 498.5
 Dividend Yield 0.0%

P/E (Fw 12 mos) 14.8
 P/E (Trail 12 mos) 17.5
 P/E (2008 est) 17.9
 P/E (2009 est) 15.3

Price/Sales 0.41
 Price/Book 3.42
 Book Value/Share \$11.93

Management Quality Above Avg
 Earnings Quality Not Acceptable

Stock Activity

52-Week high \$54.63
 52-Week low \$29.80
 Avg. Volume (60d) 39.8
 Beta 0.43

Price Return - 1 mo 15.79%
 Price Return - 3 mo -13.76%
 Price Return - 6 mo -7.25%
 Price Return - 1 yr -15.99%

Return vs S&P - 1 mo -1.87%
 Return vs S&P - 3 mo 12.87%
 Return vs S&P - 6 mo 26.82%
 Return vs S&P - 1 yr 23.38%

Recommendation: Medco Health Solutions (MHS) is the largest pharmacy benefits manager (PBM) in the nation, providing services that aid in reducing healthcare costs and increasing the availability of needed treatments for approximately 60 million patients in the U.S. The company's core competency remains in offering lower priced pharmaceuticals to patients by passing on the cost savings gained from volume purchasing and promoting generic drug usage as an alternative to higher-priced patent-protected drugs. MHS reports that 64% of total prescriptions filled are generic, a significant improvement from the 44% generic dispensing rate it reported in 2003. With \$60 billion worth of branded pharmaceuticals' patents expiring by 2011, we expect further improvement in the generic utilization rate, patients' cost savings and MHS' margin expansion.

Our target price of \$51 suggests 22% upside. We initiate a Buy rating for MHS stock and will continue to hold it in the AFG50 portfolio as a Health Care holding.

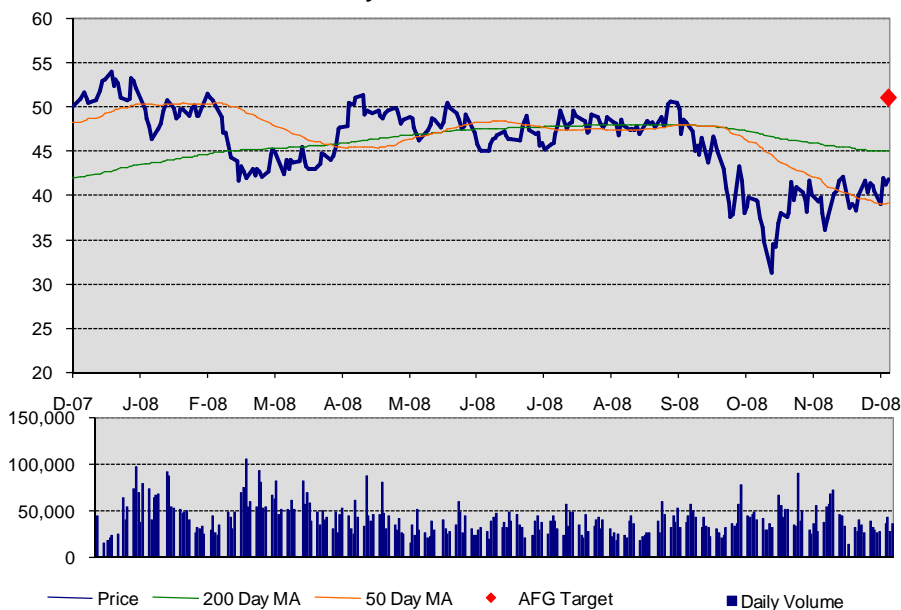
Company Description:

The Company is a pharmacy benefit manager whose prescription drug benefit programs are designed to drive down the cost of pharmacy healthcare for private and public employers, health plans, labor unions and government agencies.

Recent Events:

- MHS announced a partnership with drugstore.com to offer non-prescription health-related products to consumers on an online platform. The online store is expected to launch in mid-2009, designed to cater to patients' specific health needs. The one-stop shopping experience will recommend over-the-counter products suited for treating consumers' conditions, as well as alert them of interactions with prescription drugs they may already be taking.
- In September, data from an MHS study shows that seniors taking cholesterol-lowering statins covered by Medicare often stop purchasing drugs when they reach the Coverage Gap (doughnut hole), or switch to lower-priced generic statins. The company has launched a nation-wide communications program to inform its members that switching to generics early can help prolong or avoid the Coverage Gap problem, which should help increase generic sales.

1-year Price Performance



Pros

1. Industry: Positive market characteristics

- The demographic in the United States consists of an aging population that is living longer and increasing in number. The Baby Boom demographic has begun to retire and will continue to do so within the next 2 decades, increasing the need for health care products, such as pharmaceuticals that treat ailments like heart disease, diabetes, cancer, and pain. Baby Boomers, which represent 76 million Americans, are expected to live for at least 20 years beyond retirement, and are seen as the driving force behind increased pharmaceutical use.
- Health care costs are on the rise and patients are relying more on Medicare or employer-based medical insurance to provide for health care coverage. Prices for branded pharmaceuticals often come with high price tags, due to extensive research and expensive clinical trials conducted by pharmaceutical manufacturers. The lower cost mail order capabilities that PBMs offer, compared to traditional pharmacy services, give insurers a better option when attempting to control rising health care benefit costs for their beneficiaries.
- The growing popularity of generic drugs, together with an increasing number of branded drugs going off patent, result in higher profit margins for PBMs as they can purchase generic drugs from manufacturers at a greater discount. PBMs generally purchase branded drugs from wholesalers at less favorable prices. With generics expected to account for about 65% of all prescriptions dispensed in the U.S. in 2008, up from 48% in 2002, the savings are substantial. For MHS, higher generic dispensing rates translate into expanded margins. EBITDA margins increased 180 bps from 2002 to 2007. The loss of branded drugs' patent exclusivity from 2002 to 2005 represented \$31 billion of sales that were subject to generic competition. In 2006 and 2007 alone, almost \$30 billion of sales were subject to generic competition. Furthermore, from 2008 – 2011, a projected \$60 billion of U.S. drug patent expirations will face off with generics.

2. Coveted Medicare Exposure

- With the initiation of Medicare Part D in 2006, the U.S. government has become the largest purchaser of pharmaceuticals, representing approximately 40% of the market. MHS is 1 of only 17 companies approved by the Centers for Medicare and Medicaid Services (CMS) as a direct contract Prescription Drug Plan (PDP) sponsor. As a national PDP sponsor, MHS is reimbursed for all covered drug costs plus any administrative costs that could be imbedded in the annual bid price, as opposed to only receiving a drug expense subsidy. The result is favorable profitability, compared to a non-sponsored employer primary drug coverage provider who only receives drug subsidies for its Medicare-eligible retirees.
- As the U.S. economy struggles in a recession and the unemployment rate has risen above 6.5%, more Americans may be relying on COBRA health care coverage to extend their current health benefits for up to 18 months after losing their job. However, COBRA is expensive, since the enrollees have to cover 102% of their prior insurance premium the entire time they remain on COBRA. If the economy does not improve, expiration of COBRA coverage can lead to an increasing number of Americans without adequate drug coverage. In contrast, the Medicare population mostly consists of retired seniors not at risk of losing their coverage. Therefore, PBM companies with direct Medicare exposure are likely to perform better financially, compared to PBMs without significant exposure to Medicare, as some of their health insurance clients may experience membership loss. Currently 25 million Medicare members have enrolled in the Part D plan, while the remaining 18 million eligible for the drug plan are either covered under veteran's benefits, private insurance or simply not covered at all. Any shift toward Part D can result in Medicare business growth for MHS.

3. Growth Prospects

- International penetration: During Q2 08, MHS acquired a majority interest in privately held Europa Apotheek Venlo B.V., a Netherlands-based mail-order pharmacy services company operating in Germany and the Netherlands. The \$120 million acquisition signals MHS' first international presence. MHS has expressed its interest to further expand in Europe.
- Universal health care: During his presidential campaign, President-elect Barack Obama announced his support for universal health coverage in the U.S. It is estimated that 46 million Americans are uninsured, and most will receive health care coverage if the Democratic-led Congress can corroborate with Obama. A surge in insured Americans will likely demand more health products such as pharmaceuticals.
- Follow-on biologics (biosimilars): Generic versions of biopharmaceuticals are currently not allowed to be marketed in the U.S. However, Congress has been negotiating with the biopharmaceutical industry over biosimilar safety and effectiveness issues, as well as an exclusivity period for biotech companies that are burdened with years of expensive R&D. If Congress passes a law that provides a regulatory pathway with proper FDA oversight, billions of dollars of biologics may be threatened by lower-priced biosimilars, and PBMs may benefit.

Cons

- A change to Medicare and Medicaid policy with regard to government reimbursement cuts for health care products and services could adversely affect the profitability of pharmacy benefit management providers.
- A change in the company's ability to cover its financial obligations, or a significant increase in the company's total debt could adversely affect its credit ratings. Currently, MHS earns the lowest investment-grade rating issued from all 3 major rating agencies; Moody's rates MHS at Baa3, while Fitch and S&P both rate the company at BBB.

Q3 08Earnings:

Net income increased 38% to \$296 million, or \$0.58 per diluted share, compared with \$215 million, or \$0.39 per diluted share, a year ago.

Sales:

Sales increased 15% to \$12.6 billion, compared with \$10.9 billion a year ago.

- PBM sales increased 12% to \$10.5 billion due to the contribution from the PolyMedica acquisition, as well as higher prices for some branded drugs.
- Specialty Pharmacy sales jumped 34% to \$2.0 billion, due mostly to the inclusion of sales from the Critical Care acquisition.

Margins:

- EBITDA margin expanded 54 bps to 4.9%, due to increased generic mix in the PBM segment.
- Operating margin expanded 53 bps to 4.0%
 - PBM operating margin expanded 55 bps to 4.1%, compared to 3.5% a year ago.
 - Specialty Pharmacy operating margin grew by 37 bps to 3.9% from 3.5% a year ago.

Generic Utilization:

The company's generic dispensing rate increased 410 bps to 64.4%.

- Retail generic dispensing rate increased 420 bps to 66.4%.
- Mail-order generic dispensing rate increased 490 bps to 55.8%

Prescription Growth:

Total adjusted prescriptions grew 6% to 193 million.

- Retail prescriptions grew 2% to 115.1 million
- Mail-order volume increased 11% to 26.1 million prescriptions, due to a new large mail-order-only client win in early 2008.
 - The adjusted mail-order penetration rate improved by 200 bps to 40.4%.

Common Stock:

MHS repurchased 8.3 million shares of common stock at a cost of \$392 million.

OutlookEPS:

- 2008 adjusted EPS is expected to be within the range of \$2.10 - \$2.13, an increase of 30% from 2007. Adjusted to exclude amortization of intangibles from the 2003 spin-off from Merck, EPS is expected to be \$2.30 - \$2.33.
- 2009 guidance calls for EPS of \$2.45 - \$2.55, 18% higher than the EPS guidance range for 2008. Adjusted to exclude an intangible amortization charge, the EPS range is \$2.67 - \$2.77.

Common Stock:

In October 2008, the Board of Directors authorized a \$3 billion share repurchase plan. The new authorization replaces the previous \$5.5 billion share repurchase plan that was completed in October.

Mail-Order Prescriptions:

Mail-order prescriptions are expected to be 105 million at the end of 2008, representing 11% growth over 2007.

- Mail-order penetration rate is expected to be 39% in 2008.
- Mail-order penetration rate is expected to be 38% in 2009, due to account losses (GE and Bellsouth), which are heavy users of mail-order prescription delivery.

AFG Valuation:

	2005	2006	2007	2008E	2009E	2010E	2011E	2012E		
Sales Growth (%)	7.13	12.34	4.61	15.00	5.00	4.00	4.00	4.00	Market Price	\$41.81
Ebitda Margins (%)	3.57	3.45	4.49	4.80	5.00	5.50	5.75	6.00	AFG Target Price	\$50.93
Asset Turns	2.76	2.96	2.74	3.10	3.13	3.13	3.12	3.09	Percent to Target	21.8%

We project mid-single-digit sales growth for the next 5 years, with the exception of 2008. The anniversary of companies acquired in 2007 will account for double-digit sales growth in 2008. Our long-term projection reflects a conservative view on organic sales growth. Additionally, we modeled an expansion to EBITDA margins for the next 5 years, driven by further improvement in generic utilization, growth in the home delivery business, and continued focus on specialty pharmacy business. Our projections show that MHS shares are undervalued.

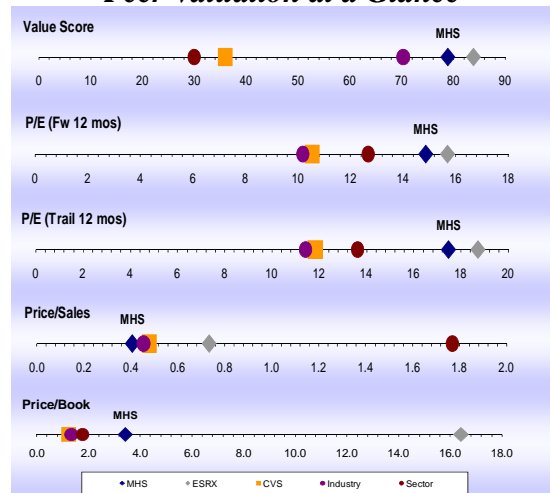
The table below shows that MHS enjoys one of the highest value scores in its peer group. Also, the company's P/E multiples are comparable with ESRX, its only pure-play direct competitor.

Market Multiples:

Peer Comparison

	MHS	ESRX	CVS	Industry	Sector	S&P 500
Value Score	78	85	39	70.5	29	54
P/E (Fw 12 mos)	14.8	15.7	10.5	10.2	12.7	10.3
P/E (Trail 12 mos)	17.5	18.7	11.9	11.4	13.6	10.3
Price/Sales	0.4	0.7	0.5	0.5	1.8	0.8
Price/Book	3.4	16.4	1.2	1.4	1.8	1.6
Price/Cash Flow	13.8	24.0	5.9	7.5	4.1	5.3

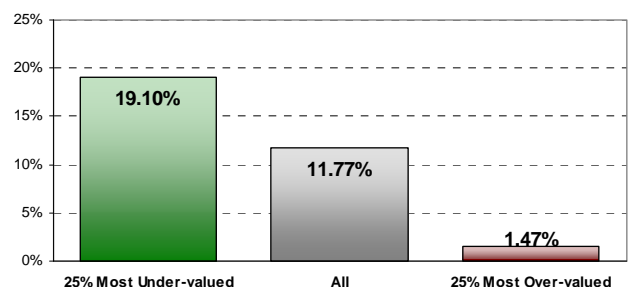
Peer Valuation at a Glance



Fact: Companies that are undervalued based on AFG's Percent to Target metric outperform the market and their overvalued peers.

Companies with a Value Score greater than 75 (upper quartile of valuation) outperformed the total universe of stocks by 733 basis points annually while companies with a Value Score less than 25 (bottom quartile of valuation) underperformed the universe by 1,030 basis points.

Returns of Cheap and Expensive Companies
(annualized, 3/96 to 2/08)



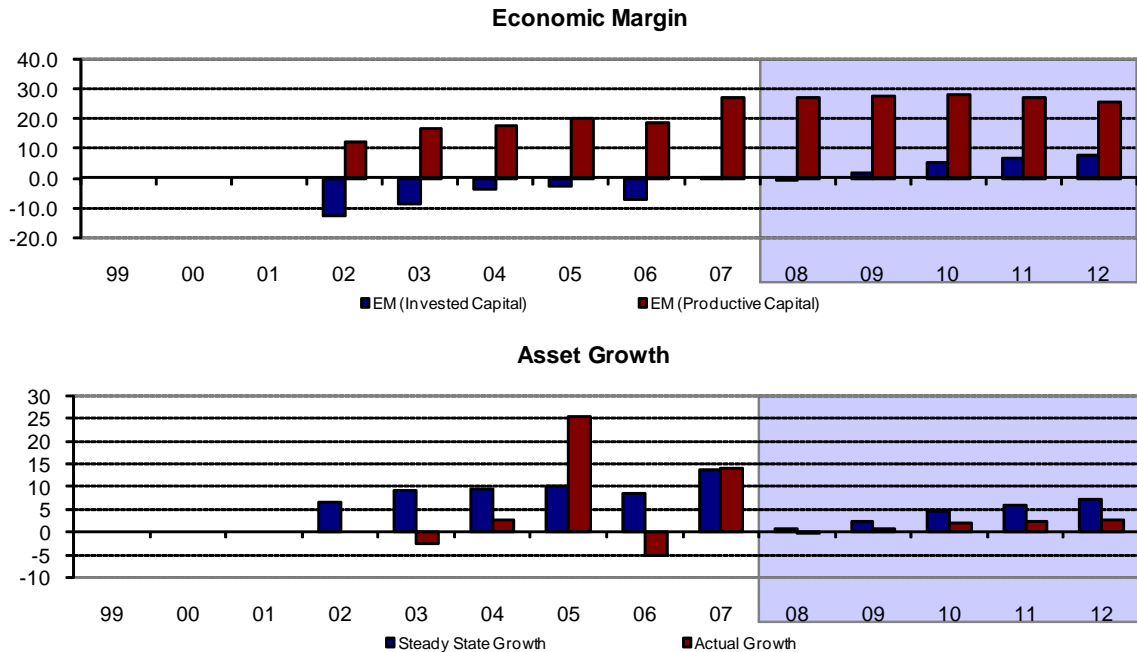
Key Ratios
MEDCO HEALTH SOLUTIONS (MHS)
Annual Data
Quarterly Data

	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>Q4 07</u>	<u>Q1 08</u>	<u>Q2 08</u>	<u>Current Q3 08</u>
Short-Term Liquidity								
Current Ratio	1.63	1.35	1.21	1.23	1.23	1.22	1.26	1.25
Quick Ratio	1.14	0.94	0.87	0.85	0.85	0.85	0.86	0.86
Cash Ratio	0.43	0.24	0.17	0.15	0.15	0.10	0.07	0.09
Capital Structure								
Debt to Capital	17.3%	16.0%	14.4%	33.7%	33.7%	40.4%	44.1%	43.7%
Debt to Equity	20.9%	19.0%	16.9%	50.8%	50.8%	67.9%	78.8%	77.7%
Times Interest Earned	20.8	33.8	22.3	20.0	12.9	11.3	10.5	10.6
Return on Investment								
Economic Margin	17.9%	20.2%	18.8%	27.1%	n/a	n/a	n/a	n/a
Return on Equity	8.9%	9.0%	8.3%	12.7%	12.7%	13.6%	15.0%	16.6%
Return on Capital	7.2%	7.5%	7.0%	9.5%	9.5%	9.5%	9.8%	10.8%
Pre-tax Return on Assets	7.8%	7.9%	7.2%	9.8%	9.8%	9.9%	10.2%	11.1%
Operating Measures								
Gross Margin	4.4%	4.6%	5.1%	6.1%	6.2%	6.4%	6.8%	6.8%
Ebitda Margin	3.5%	3.6%	3.5%	4.5%	4.2%	4.7%	4.7%	4.9%
Operating Margin (Ebit)	2.5%	2.6%	2.5%	3.6%	3.3%	3.9%	3.9%	4.0%
Pretax Margin	2.3%	2.5%	2.4%	3.4%	3.0%	3.5%	3.4%	3.6%
Efficiency Ratios								
Receivables Turnover	24.0	21.3	17.6	15.1	15.1	14.8	15.0	15.9
Days Receivables	15.2	17.2	20.7	24.2	24.2	24.6	24.4	23.0
Inventory Turnover	26.7	25.4	25.2	23.1	23.1	23.7	24.5	24.5
Days Inventory	13.7	14.4	14.5	15.8	15.8	15.4	14.9	14.9
Working Capital Turnover	25.0	25.5	36.5	40.4	40.4	46.2	38.2	44.9
Asset Turnover	3.40	3.12	3.03	2.91	2.91	3.05	3.11	3.31

Debt increased in 2007 and 2008 in order to finance acquisitions and to repurchase shares. In 2007, MHS acquired PolyMedica and Critical Care, with the Europa Apotheek acquisition closed in Q2 08. Total debt is expected to remain the same through the end of 2009, while the company focuses on increasing its cash balance to improve its liquidity position.

All return metrics and margins have improved over the last few quarters, due to higher profitability from increased generics and mail order penetration rates, as well as the integration of specialty services business from the Critical Care acquisition. These metrics are expected to continue to expand.

Lower efficiency ratios in 2005 and 2007 were caused by the Accredo and PolyMedica acquisitions. However, improvements have been accomplished in the most recent quarter. We expect continued turnover improvement, as management focuses its efforts to improve efficiency.



Summary:

After spinning off from Merck in 2003, MHS became the largest PBM operating in the U.S. Strategic acquisitions over the past several years helped MHS maintain its leadership position, currently surpassing its closest competitor’s annual sales by \$5 billion. The company became the country’s largest provider of specialty pharmacy services when it acquired Accredo Health and diabetes pharmacy care services with its PolyMedica acquisition in 2005 and 2007, respectively.

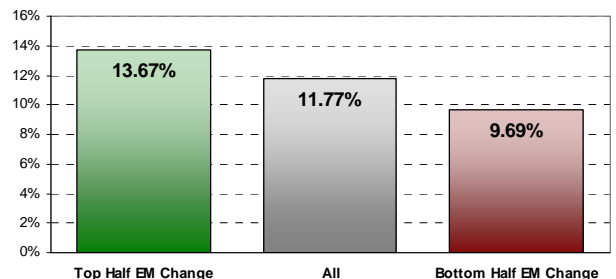
After issuing 24 million shares to fund a portion of its Accredo Health acquisition, MHS has been aggressively buying back its common stock. Shares outstanding have declined by 111 million shares, or 18% since 2005. The company continues to expect to repurchase its common stock, and we projected minimal organic asset growth going forward.

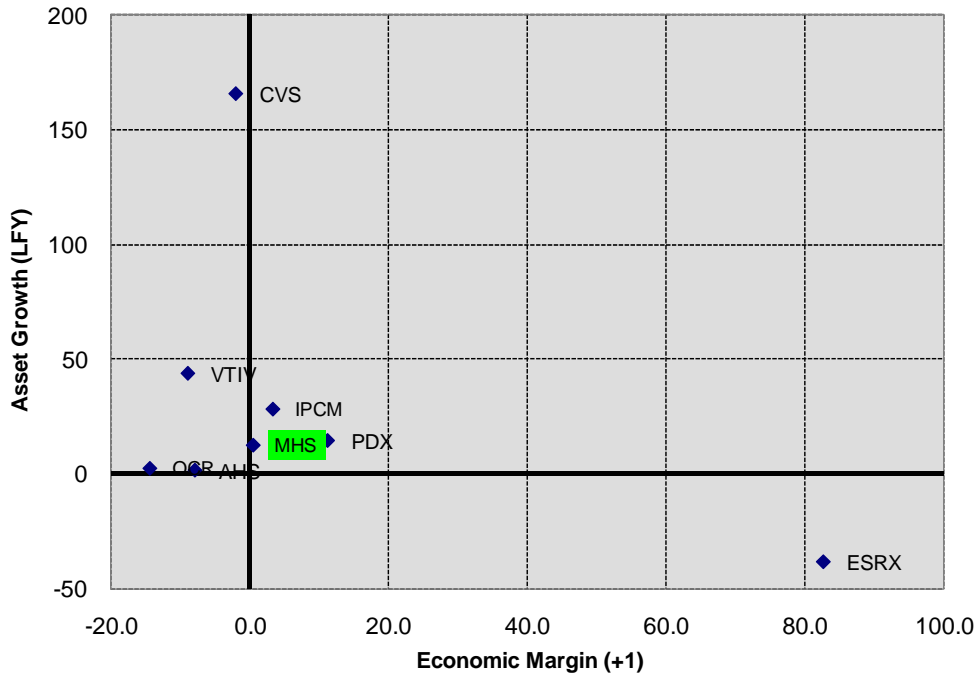
Just the Facts...

Fact: Companies with relatively improving Economic Margins tend to outperform the market and their peers.

Companies ranked in the top half of expected EM Change outperformed the market by over 190 basis points annually while companies with below average EM Change under performed by 208 basis points annually.

Returns of Improving and Deteriorating Economic Margins (annualized, 3/96 to 2/08)





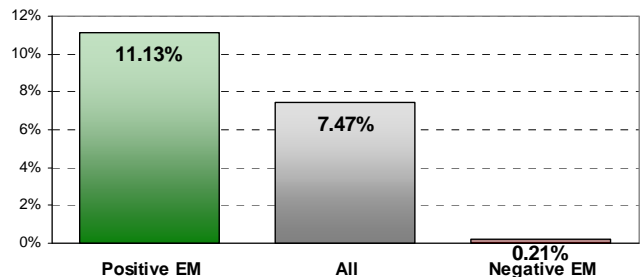
Huge acquisitions resulted in very low EM (IC) projections for competitors MHS and CVS, due to the size of intangibles on the books. ESRX holds a strong EM but has realized negative asset growth due to aggressive share buybacks. We believe that ESRX’s very high EM is unsustainable and will decline over time, while MHS is likely to experience EM expansion.

Just the Facts...

Fact: Companies with positive Economic Margins and strong asset growth create shareholder wealth and outperform peers.

Among companies with strong asset growth (greater than 10% annually), companies with positive Economic Margins outperform those with negative Economic Margins by a significant amount.

Returns of Companies Growing Assets >10% Annually
(annualized, 10/96 to 2/08)



MEDCO HEALTH SOLUTIONS (MHS)
Annual Income Statement

	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	Forecast Data	
						<u>2008E</u>	<u>2009E</u>
Sales	34,265	35,352	37,871	42,544	44,506	51,182	53,741
<i>Sales Growth</i>		3.2%	7.1%	12.3%	4.6%	15.0%	5.0%
Cost of Goods Sold ex DDA	32,553	33,432	35,763	39,965	41,392	47,448	49,716
DD&A Expense	283	378	358	392	397	445	463
SG&A Expense	686	676	758	1,109	1,114	1,277	1,338
Operating Income	741	866	993	1,078	1,603	2,012	2,224
<i>Operating Margin</i>	2.2%	2.5%	2.6%	2.5%	3.6%	3.9%	4.1%
Pretax Income	729	806	953	1,012	1,503	1,783	1,984
Tax Expense	303	325	351	382	591	672	748
Net Income for Common	426	482	602	630	912	1,110	1,236
Special Items	-86	0	-174	0	-166	0	0
Net Income to Common Adj SI	480	482	711	630	1,017	1,110	1,236

Annual Balance Sheet

	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	Forecast Data	
						<u>2008E</u>	<u>2009E</u>
Cash	639	1,146	888	819	774	732	796
Receivables	1,394	1,555	2,008	2,827	3,073	3,412	3,839
Inventories	1,213	1,316	1,527	1,677	1,946	1,977	2,075
Other Cur Assets	514	304	638	533	510	483	525
Total Cur Assets	3,760	4,320	5,061	5,855	6,303	6,604	7,234
Net PP&E	757	658	672	650	726	782	821
Net Intangibles	5,631	5,451	7,894	7,632	9,135	9,074	9,074
Other Assets	115	113	76	252	55	52	56
Total Assets	10,263	10,542	13,703	14,388	16,218	16,511	17,185
Total Cur Liabs	2,605	2,645	3,761	4,827	5,129	5,176	5,629
Long Term Debt	1,346	1,093	944	866	2,894	3,992	4,192
Total Liabs	5,183	4,822	5,979	6,885	9,343	10,435	11,133
Total Equity	5,080	5,719	7,724	7,504	6,875	6,077	6,053
Total Liabs & Eq	10,263	10,542	13,703	14,388	16,218	16,511	17,185

Economic Margin:

This is AFG’s proprietary measure of corporate performance. An Economic Margin (EM) measures the return a company earns above or below its cost of capital. This measure considers three important factors; 1) the amount of Cash Flow a firm is generating, 2) the capital base from which the cash flow is derived, and 3) the opportunity cost of employing that capital. Firms with a positive EM are generating Operating Cash Flow beyond the cost of the capital employed, thus creating investor wealth. An EM makes the connection between the level of cash generated and the investments made to generate that cash, effectively linking the income statement and balance sheet. Accounting measures such as Earnings fail to make this connection.

$$\text{Economic Margin} = \frac{\text{Operations Based Cash Flow} - \text{Capital Charge}}{\text{Inflation Adjusted Invested Capital}}$$

Operations Based Cash Flow:

- + Net Income
- + Depreciation & amortization
- + After Tax Interest Expense
- + Rental Expense Net Int. Adj.
- + R & D Expense
- ± Non-Recurring Items

Capital Charge:

Return *on* and Return *of* Capital
that captures company specific
economic circumstances.

Inflation Adjusted Invested Capital:

- + Total Assets
- + Accumulated Depreciation
- + Gross Plant Inflation Adjustment
- + Capitalized Operating Rentals
- + Capitalized R & D
- Non Debt Current Liabilities

EM Change:

Not only is a firm’s level of Economic Margins important, but so too is the direction of EM change. EM Change is defined as the EM+1 forecast minus the reported LFY EM. Our empirical evidence has proven a strong relationship between improving Economic Margins and expanding market multiples. A useful measure of corporate performance should carry a systematic link to performance in the stock market. Identifying stocks with expected improvement in EMs helps identify stocks that will outperform in the market.

Percent to Target:

Measures the deviation between a stock’s current market price and AFG’s price target. For example, a stock with a \$10 price with a \$12 target would carry a 20% upside, or 20% to Target. AFG target prices utilize a discounted cash flow analysis to arrive at an equity value for each company. The terminal value of this DCF is determined by a *decay* of Economic Margins (spread above the cost of capital). Each company’s EMs are decayed to 0 over a certain number of years based on the individual characteristics and competitive advantages of that firm. When a company’s EM reaches a value of 0, all incremental investments are zero NPV propositions, thus ending the wealth creation of the firm.

Value Score:

Value score is simply a ranked Percent to Target. Value Scores range from 0 to 100, representing a stock’s attractiveness relative to its sector. An attractive stock based on valuation might have a value score of 90, suggesting that, based on valuation alone, the stock is more attractive than 90% of the stocks in that particular sector.

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