Bond Analysis: CVS Health Corp

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Bond Recommendations:

Bond	Conservative	Moderate	Aggressive
2025	OVERWEIGHT	MARKETWEIGHT	UNDERWEIGHT
2028	OVERWEIGHT	MARKETWEIGHT	UNDERWEIGHT
2031	MARKETWEIGHT	UNDERWEIGHT	UNDERWEIGHT

ABOUT THE COMPANY

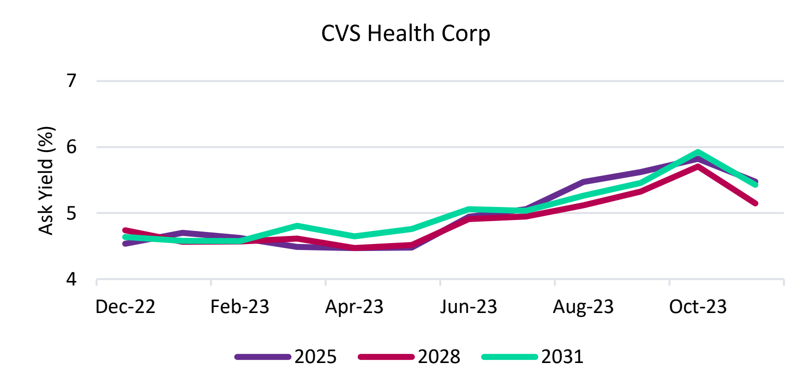
CVS Health Corporation (CVS) is an American healthcare company that was founded in 1963 and operates through three fundamental businesses, including: Health Care Benefits, Pharmacy Services and Retail.

With more than 9,900 retail locations and 1,100 walk-in medical clinics, CVS seeks to improve access, lower costs, and enhance health outcomes by engaging with consumers when, where and how they desire. This means delivering solutions that are personalized, seamless, connected and increasingly digital. CVS Health is also shifting from transaction-based primary care to addressing holistic health – physical, emotional, social, economic – which will lead to higher quality of care and lower medical costs.

CVS is a leader in key segments of healthcare today through foundational businesses and is seeking to create new sources of value by expanding into next generation primary care delivery and health services, with a goal of improving satisfaction levels for both providers and consumers.

In 2018, CVS acquired Aetna to build an integrated healthcare system. In March 2023, CVS completed the acquisition of Signify Health to enhance value-based care. In August 2023, CVS launched Cordavis, a subsidiary focused on collaborating with pharmaceutical manufacturers for biosimilar product development.

CVS Health Corp: Bond Term Summary			
Issuer	CVS Health Corp.		
Currency	USD		
Maturity	07/20/25	03/25/28	09/15/31
Issued Amount	$3.0 bn	$9.0 bn	$1.0 bn
Issue Date	07/20/15	03/09/18	08/18/21
Tenor	2 Years	5 Years	8 Years
Indicative Price (Dec 20, 2023)	$98.152	$98.136	$82.501
Ask Yield to Maturity (Dec 20, 2023)	5.171%	4.810%	4.937%
Coupon	3.875%	4.300%	2.125%
Maturity Type	Callable on 04/20/25	Callable on 12/25/27	Callable on 06/15/31
Credit Rating (S&P)	BBB		
Outlook (S&P)	Stable		
Day Count Basis	30/360		
Use of proceeds	Acquisition Financing, Bridge-Loan Payment, General Corporate Purposes		



Recommendation: The company's leverage position has risen due to recent mergers and acquisitions, increasing debt and impacting its operating cash flow. Despite this change, we anticipate an increase in profitability as the newly integrated companies enhance the ability to make interest payments. Because the bonds are selling below par and have closer call and maturity dates, we have assigned an overweight rating to both the 2025 and 2028 bonds, catering to conservative investors. Even though the 2031 bond is likewise trading at a discount, investors are still exposed to the bond's maturity risk, thus the yield does not adequately compensate for it. The recommendations range from marketweight to underweight since the bonds offer comparatively modest returns when compared to the present interest rate appetite by both aggressive and moderate investors.

ECONOMIC OVERVIEW (UNITED STATES)

In Q3 2023, the US Bureau of Economic Analysis revised real GDP growth to 5.20%, up from the initial 4.90%. The Institute for Supply Management (ISM) Manufacturing PMI has consistently remained below 50%, signaling contractions within the manufacturing sector, while the Services sector continues to expand. Despite a boost in manufacturing employment from workers returning after an auto strike, the November 2023 unemployment rate increased to 3.70%, up by 20 basis points. November's point-to-point inflation rate decreased to 3.14%, a 10 basis points drop from October. The US economy's resilience, along with robust labour market conditions and a declining inflation rate, suggests a 'soft landing' for the US Federal Reserve. After implementing a series of rate hikes to control inflation, the Fed paused at 5.25% - 5.50% in December 2023.

Fitch Ratings downgraded the US from the highest AAA classification to AA+ due to a steady deterioration in standards of governance in recent decades on fiscal and debt matters, among other issues. Additionally, Moody's Investors Service downgraded the outlook on US Government ratings from stable to negative, while maintaining the long-term issuer and senior unsecured ratings at Aaa. The primary reason for this change is Moody's assessment that the downside risks to the fiscal strength of the US have increased and may no longer be fully balanced by the sovereign's unique credit strengths. With the backdrop of rising interest rates, Moody's anticipates that the fiscal deficits in the US will persist at substantial levels, significantly undermining debt affordability.

NINE MONTHS ENDED SEPTEMBER 30, 2023 (9M 2023)

$ (millions)	FY 2021	FY 2022	9M 2022	9M 2023
Net Operating Income	292,111	322,467	238,621	263,963
Operating Costs	278,918	314,721	234,326	253,593
EBITDA	17,705	11,993	7,476	13,602
Interest Expense	2,503	2,287	1,735	1,968
Total Debt	56,176	52,254	52,211	61,914
Operating Cash Flow	18,265	16,117	18129	16,062
Total Shareholders' Equity	75,381	71,315	71,011	74,510
Interest Coverage Ratio (x)	7.07	5.24	4.31	6.91
Debt Service Ratio (x)	2.64	2.95	2.41	3.32
Total Debt to Equity	74.52%	73.27%	73.53%	83.09%

For the nine-month period ending on September 30, 2023, CVS witnessed a growth in operating revenue, rising from $238.6 million to $263.96 million, reflecting a notable10.62% increase. This upswing signifies enhanced profitability across all segments of the company's operations. Despite a rise in operating costs from $234.33 million to $253.59 million, an 8.22% increase, the concurrent growth in net operating income implies that the company effectively generated elevated revenues to offset these heightened costs. However, it is noteworthy that the operating efficiency ratio, although experiencing a decrease of 213 basis points, remained relatively high at 96.07%.

EBITDA demonstrated a significant surge, escalating from $7.48 million to $13.6 million, indicating improved operational performance and efficiency. While interest expenses saw a slight uptick from $1.74 million to $1.97 million, a 13.43% increase, this rise was attributed to the US Federal Reserve's interest rate hikes aimed at mitigating record-high inflation. Despite the heightened interest expenses, the interest coverage ratio improved from 4.31x to 6.9x, indicating the company's increased capacity to cover interest costs with its EBITDA. This is a positive indicator of the company's financial well-being. Ultimately, net income experienced substantial growth, more than tripling from $1.99 million to $6.32 million by the end of the nine-month period.

Total debt increased from $52.21 million to $61.91 million, signalling CVS's adoption of additional debt, which could potentially impact its financial leverage and interest obligations. Simultaneously, operating cash flow witnessed a decrease from $18.13 million to $16.06 million, raising concerns about the company's ability to meet its augmented financial commitments. Total shareholders' equity exhibited a positive trend with a 4.93% increase, progressing from $71.01 million to $74.51 million, indicating positive changes in the company's net assets. However, the total debt to equity ratio rose from 73.53% to 83.09%, suggesting an increased reliance on debt financing in comparison to equity. Meanwhile, the debt service ratio improved from 2.4x to 3.32x, showcasing an enhancement in CVS's ability to service its growing debt obligations.

ISSUER RATINGS ANALYSIS

Standard & Poor's: BBB/Stable

On December 13, 2022, S&P Global Ratings (S&P) adjusted its outlook from positive to stable and confirmed all CVS ratings, including the 'BBB' issuer credit rating and issue-level ratings. CVS faces the challenge of striking a balance between a prudent capital allocation strategy and ongoing mergers and acquisitions (M&A) to stay competitive in the swiftly changing healthcare sector. The shift to a stable outlook indicates that, considering recent earnings and financial policy guidance, CVS is expected to maintain a leverage above 3x on an S&P Global Ratings-lease-adjusted basis in the next one to two years. The rating and outlook were affirmed on May 15, 2023.

Moody's Ratings': Baa2/Stable

On December 19, 2023, Moody's Investors Service (Moody's) affirmed CVS's ratings, including the Baa2 senior unsecured notes ratings, the Prime-2 senior unsecured commercial paper rating, and the (P)Baa2 senior unsecured shelf rating, while maintaining a stable outlook. The Baa2 rating is indicative of CVS's extensive scale, prominent positions in pharmacy benefit management and retail operations, and the robust reputation of its Aetna brand in health insurance. The stable outlook is based on CVS's leading market position, the breadth of its services, and its robust cash flow. Moody's expects CVS to utilize a combination of internal cash flow and additional debt as earnings grow to support shareholder payouts and potential acquisitions.

BOND RATINGS ANALYSIS

Standard & Poor's: BBB/Stable

On February 13, 2023, S&P Global Ratings (S&P) assigned a 'BBB' issue-level rating to CVS's proposed senior unsecured notes. S&P anticipates that the proceeds from these notes will be utilized for general corporate purposes, included partially funding the acquisition of Signify Health. Additionally, CVS revealed its intention to acquire Oak Street Health Inc. for approximately $10.60 billion in cash, a transaction that concluded in May 2023. Given the considerable size and complexity of integrating Signify and Oak Street, S&P does not foresee CVS pursuing further large-scale mergers or acquisitions in the near term. Instead, the focus is expected to be on maintaining, or potentially reducing, leverage in fiscal year 2024, if not earlier.

OUTLOOK

Increased Profitability

The acquisitions will expand CVS's value-based primary care platform, offering substantial advantages to patients' long-term well-being through enhanced outcomes and lowered costs, especially for those in underserved communities. Anticipated increases in earnings and cash flow, achieved through the successful integration of Oak Street and Signify, coupled with the effective implementation of the new pharmacy reimbursement model, are projected to enhance profitability, reduce leverage, and improve liquidity. This is also anticipated to maintain the debt/EBITDA ratio below 3.50x.

Dedicated to Enhancing Health Results

The company's shift from traditional retail to a diversified healthcare approach is essential yet intricate. CVS emphasizes its commitment to enhancing health outcomes, containing costs and broadening access to high-quality care. The company has successfully implemented these objectives, advancing primary care delivery with a 35% increase in both in-person and virtual visits from 2020 to 2021. Despite closing approximately 200 stores, CVS retained nearly 70% of prescription volume and continues to grow its home health and digital capabilities.

COMPARABLES ANALYSIS

When examining the tables comparing CVS to several peers with a similar S&P credit rating, it is observed that the coupons on the CVS 2025 and 2031 bonds are the highest, whereas the CVS 2028 falls in the middle among its peers. However, the ask yields, representing the lowest possible yields for investors, are below the comparable average for the CVS 2025 and 2031, with the CVS 2028 positioned in the middle among its peers. The CVS 2028 and 2031 feature the shortest call dates, while the CVS 2025 aligns with its peers in this aspect. Additionally, the ask yields on all three bonds are above the benchmark US 3yr, 5Yr and 7Yr treasury bills.

Issue	Rating (S&P)	Ask Yield (%)	Spread Analysis (basis points)
CVS 3.875% 2025	**BBB**	**5.12**	**108**
ZBH 3.550% 2025	BBB	5.28	124
CAH 3.750% 2025	BBB	5.13	109
US 3Yr	AA+	4.04	-

Issue	Rating (S&P)	Ask Yield (%)	Spread Analysis (basis points)
CVS 4.300% 2028	**BBB**	**4.78**	**91**
BDX 4.693% 2028	BBB	4.57	70
RVTY 1.900% 2028	BBB	5.07	120
US 5Yr	AA+	3.87	-

Issue	Rating (S&P)	Ask Yield (%)	Spread Analysis (basis points)
CVS 5.250% 2031	**BBB**	**4.87**	**95**
RVTY 2.550% 2031	BBB	5.16	124
BAX 1.730% 2031	BBB	4.90	98
US 7Yr	AA+	3.92	-

Sources: Bloomberg (December 20, 2023), US Department of Treasury

INVESTMENT POSITIVES

1. **Adequate ICR**: The ICR increased over the last 9 months, which signals CVS’s ability to meet interest payments on outstanding debt, including coupon payments and the financing the company’s recent increase in dividend payment.
2. **Continued Cost Efficiency:** The company has implemented a set of enterprise-wide cost containment measures, which aims to improve efficiency and is anticipated to continue bettering CVS’s operations through digitisation.
3. **Strong Income Potential:** CVS is anticipated to benefit from the recent mergers and acquisitions in the next 12-18 months, along with the strong pharmacy network volume.
4. **Stable Issuer Ratings:** Standard & Poor's and Moody's affirmed CVS’s issuer ratings in the last 12 months, indicating stable creditworthiness and financial stability.
5. **Consistently Robust Financial Performance:** The company has been able to grow profit annually, while improving key financial metrics such as EBITDA and ICR, which highlights its ability to maintain interest payments to bondholders.

INVESTMENT NEGATIVES

1. **The lack of geographic diversity**: CVS only has locations in the US and US territories. This exposes the company to the all the risks, including political, economic and social, associated to the US, instead of the advantages of risk reduction by operating in a dynamic and competitive global business environment.
2. **Court cases like the opioid settlement:** CVS announced an agreement to pay about $5 billion over the next 10 years beginning in 2023 to substantially resolve all opioid lawsuits by states, political subdivisions and tribal entities. This, and other similar settlements, will adversely impact EBITDA, profitability and liquidity.
3. **Changing public policy:** New public policies and regulations implemented by the government may disrupt the existing operations and procedures and ultimately pull on the company's profitability.
4. **Elevated Inflation May Lead to an Increase in Costs:** Increasing inflation and higher interest rates are expected to have a negative impact on consumer patterns and increase cost of sales, which may adversely impact profitability.

CONCLUSION

CVS is a diversified healthcare company with a significant presence in pharmacy services, retail, health benefits, and healthcare innovation. Its comprehensive approach to health and well-being reflects a commitment to providing integrated healthcare solutions to communities and individuals. The company has experienced positive changes in various financial metrics, including increased net operating income, improved EBITDA, better interest coverage, and a higher debt service ratio. However, the increase in total debt and a decrease in operating cash flow are areas that may warrant further investigation. The company should carefully manage its debt levels to ensure sustainable financial health, as it recently completed a series of mergers and acquisitions.

Therefore, we recommend that investors consider buying CVS Bonds accordingly:

Bond	Conservative	Moderate	Aggressive
2025	OVERWEIGHT	MARKETWEIGHT	UNDERWEIGHT
2028	OVERWEIGHT	MARKETWEIGHT	UNDERWEIGHT
2031	MARKETWEIGHT	UNDERWEIGHT	UNDERWEIGHT

SOURCES

CVS COMPANY WEBISTE, CVS COMPANY FINANCIALS, IMF, REUTERS, FITCH RATINGS, BLOOMBERG, STANDARD & POORS, MOODY'S INVESTOR SERVICES, US DEPARTMENT OF TREASURY

DISCLAIMER

DEFINITIONS

- **OVERWEIGHT** - Security is deemed to be undervalued and is expected to outperform compared to the average market return and/or return of comparable securities in the same sector or industry.

- **MARKETWEIGHT** – Security is expected to provide similar returns compared to the market in general or at the same pace as comparable companies; neither strongly positive nor negative.

- **UNDERWEIGHT** – Security is deemed to be overvalued and is expected to underperform compared to the average market return and/or return of comparable securities in the same sector or industry.

- **ZEROWEIGHT** – This security is substantially distressed or at risk of a shock which may significantly impair its value.