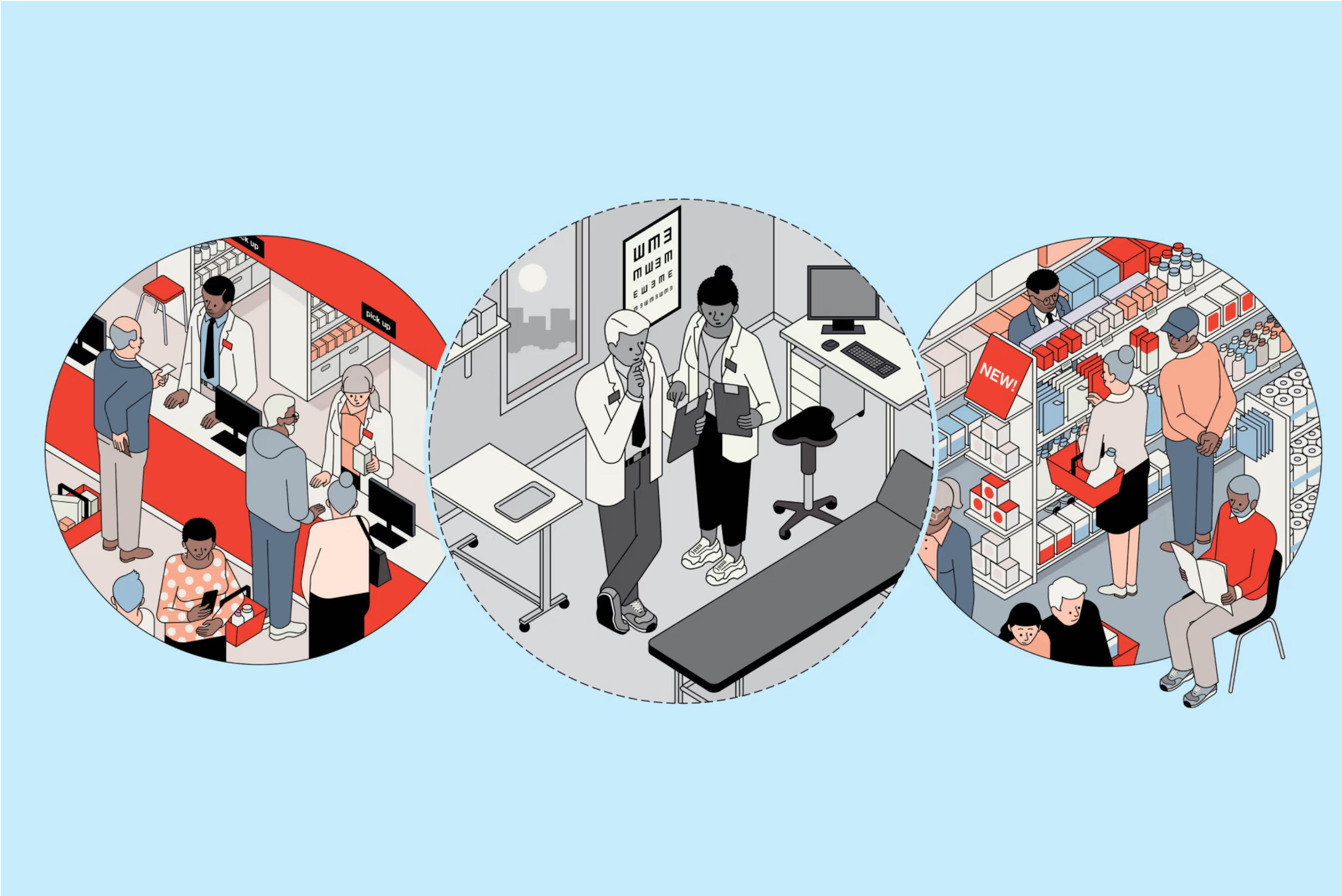

CVS has been moving toward becoming a healthcare provider for decades now. Doctors are the missing link.
ILLUSTRATION BY RAMI NIEMI

HEALTHCARE | COVER

CVS Wants to Be America's Healthcare Provider. All It Needs Now Are Doctors.

The company's primary care bet hasn't yet come to pass. Should investors be worried?

By Josh Nathan-Kazis Follow

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Late last year, CVS Health CEO Karen Lynch unveiled a new strategy: Rather than remain simply a pit stop for toilet paper and flu shots, CVS stores would become a place that Americans—particularly older ones—go to see their doctor.

It was an appealing plan, one that would take advantage of the company's breadth of vertically integrated assets, which include a major health insurer; the country's largest pharmacy benefit manager, or PBM; and a sprawling network of stores. Lynch said the company aimed to add yet another powerful link by acquiring a primary-care provider, a move that could boost earnings and, ideally, improve healthcare for seniors along the way.

A year later, the company has yet to execute on this vision—despite Lynch's insistence, as recently as August, that CVS (ticker: CVS) would make the primary-care buy "by the end of this year." The clock on that prediction is running out, but more critically, the path to the company's ultimate goal has grown increasingly thorny.

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In 2022, a surge of interest in the primary-care market exploded into a buying binge. Amazon.com (AMZN) announced a $3.9 billion deal to buy One Medical in July, while Walgreens Boots Alliance (WBA) and Cigna (CI) pitched in on an $8.9 billion deal to create a massive doctor's group that includes a primary-care chain. Walmart (WMT), meanwhile, is expanding its primary-care offering, and UnitedHealth Group (UNH) continues to snap up doctor groups.

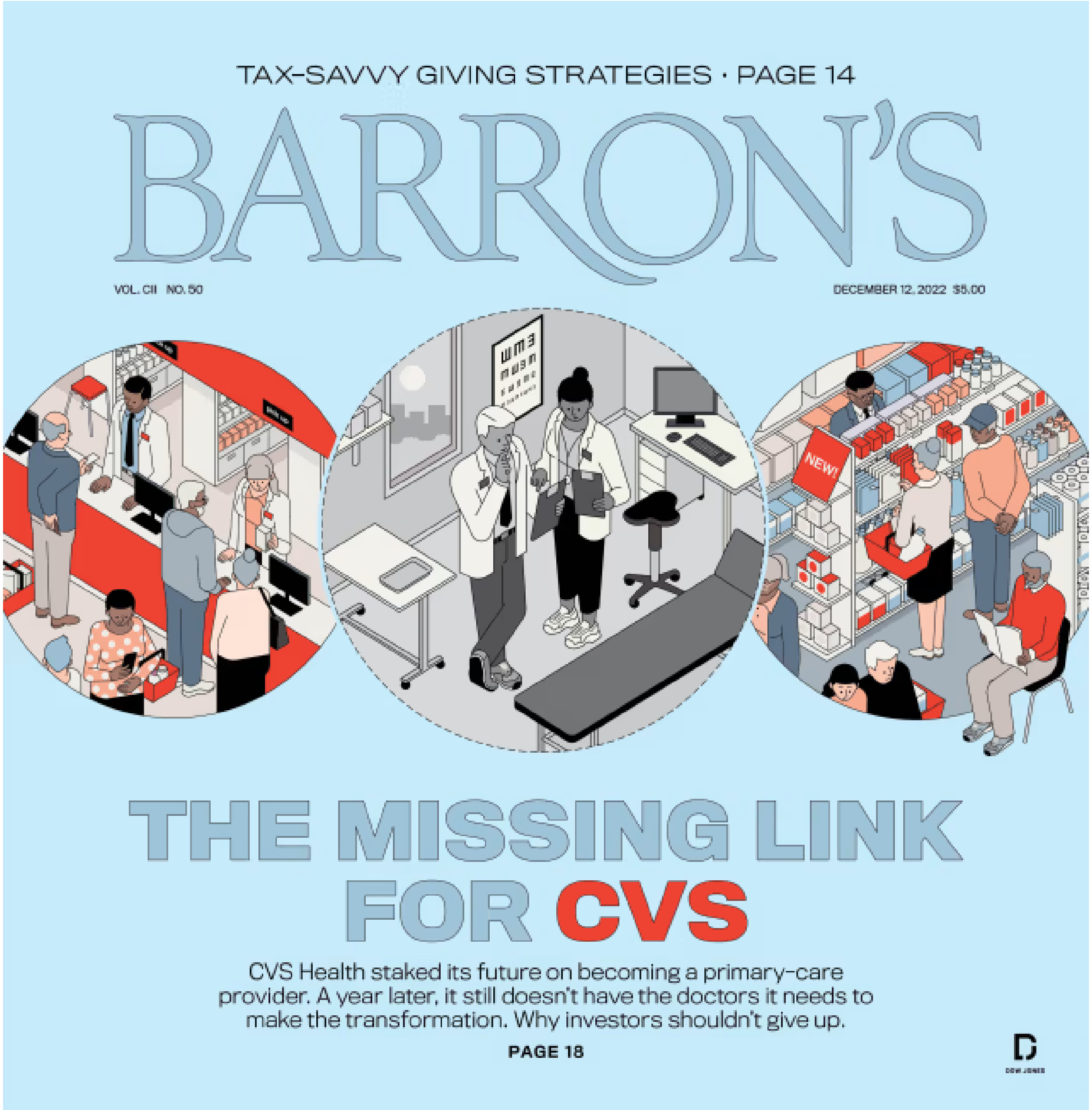


ILLUSTRATION BY RAMI NIEMI

More recently, a couple of costly new issues emerged for CVS: In October, the federal government cut the quality ratings for certain Medicare Advantage plans run by CVS' insurance arm, Aetna. That will eliminate government-paid bonuses that the company had expected to receive in 2024. Then, insurer Centene (CNC), a customer of CVS' Caremark PBM, announced that it will switch to a competitor in 2024, further ramping up pressure on earnings targets.

While CVS says it could make up for those setbacks by buying back shares, some analysts suspect that doing so would eat into funds that the company needs to get a primary-care acquisition done, especially given how competitive the market has become.

Lynch, for her part, rejects the either/or framing: “We generate a significant amount of cash, and we have the ability to deploy that cash in a variety of ways.”

Where does that leave investors? For the moment, the stock price suggests that they’re skeptical. CVS shares trade at the bargain-basement valuation of 11 times earnings expected over the next 12 months, according to FactSet. That’s a steep discount to peers like UnitedHealth, at 22 times earnings, and Humana (HUM), at 20 times earnings. CVS has the lowest valuation among all 14 large-cap stocks in the SPDR S&P Health Care Services exchange-traded fund (XHS), and the stock has remained largely flat this year, though like most health stocks, it has outperformed the broader S&P 500 index.

Karen Lynch, CEO of CVS Health, at the company’s Woonsocket, R.I., headquarters. Lynch first announced plans to push into primary care in 2021. PHOTOGRAPH BY TONY LUONG

The Street generally approves of Lynch’s grand plans, says Lisa Gill, an analyst at J.P. Morgan, but the lack of progress on the primary-care front has made the stock difficult to evaluate, since no one knows quite what form an acquisition might take. “Investors have a hard time assessing something without knowing what it is they’re going to buy,” Gill says. “They’ve been waiting a while.”

That uncertainty is warranted, and investors attached to an aggressive timeline for the company’s transformation may not find much to celebrate in the short term. But for those with a buy-and-hold approach, it’s worth delving into what roadblocks the company now faces and how likely it is to clear them. If CVS can outmaneuver its challengers, its unique structure promises that the payoff for patience could be immense.

"If they're able to do what they're hoping to do, which is transform retail pharmacy into something that becomes a point of access into the healthcare system and that people look to that as a place to get care...then, I think you've not only developed a new growth area, but you've also transformed the way people think about at least their retail pharmacies," says A.J. Rice, an analyst at Credit Suisse. "I think that would be something that would drive significantly higher valuation than they're at today."

You may think you've heard this all before, and that is understandable: CVS has been marching toward becoming a healthcare provider for decades now. You can already get vaccines, diabetes screening, and even care for some illnesses at certain CVS stores. Those services are offered at MinuteClinics (staffed largely by nurse practitioners), which CVS acquired in 2006, and at more full-service HealthHUBs, which were launched three years ago.

The difference in Lynch's current plan is twofold. First, putting doctors in CVS stores would allow the company to offer a wider range of care. And from a broader perspective, the new primary-care clinics would provide essential connective tissue between its insurance, PBM, and home-health-services operations.

Today, CVS Health's $133 billion market valuation only hints at its scale. The company owns and operates roughly 9,000 retail stores, Aetna has 24.3 million people on its insurance plans, and Caremark serves 110 million members; all told, CVS has a hand in the medical care of about a third of the American public, and that pool continues to grow: In September, the company reached an $8 billion deal to acquire Signify Health (SGFY), which assesses patients' home health needs for insurers.

"No healthcare company has ever had the collection of assets that we have," Lynch said last year. "With that comes the ability to dramatically reshape how consumers experience healthcare."

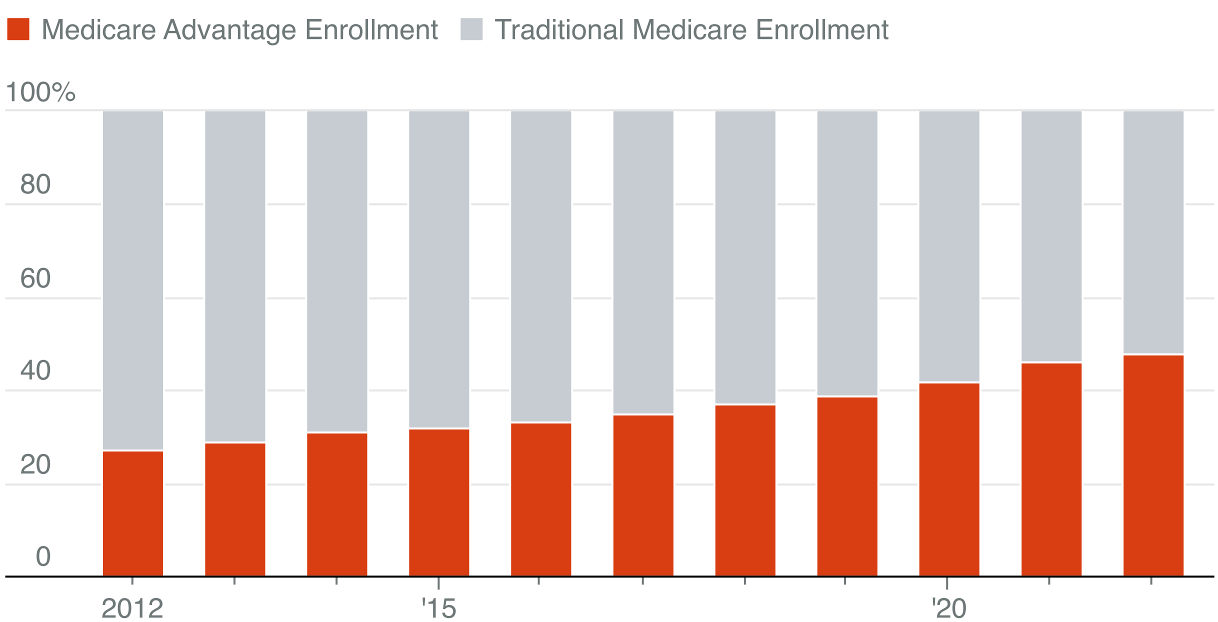
The key to Lynch's plan to do so is Medicare Advantage, the fast-growing program under which private insurers like Aetna offer government-funded insurance plans to Medicare-eligible seniors. In 2022, 48% of Medicare beneficiaries were enrolled in Medicare Advantage plans. That's 28 million people, up from 20 million in 2018.

Insurers across the industry see Medicare Advantage as an important growth market and an opportunity for substantial profits. The federal government pays high premiums for seniors on the plan, whose health needs are often complex and intensive. Insurance providers keep a share of the premiums, and, if their plans are deemed high quality by the government, they receive bonus payments; in 2022, those bonuses will amount to at least $10 billion, according to KFF, a healthcare policy group.

Here's how it could work for CVS: A senior signs up for a Medicare Advantage plan managed by Aetna. The government pays Aetna a set fee to insure the senior for the year. Aetna then cuts a deal with a primary-care provider—also owned by CVS—paying the provider a flat fee to care for the patient. The patient sees the CVS-owned primary-care doctor and nurses at a CVS-owned HealthHUB. The patient's prescriptions are filled at CVS pharmacies through Caremark, CVS' pharmacy benefit manager.

Medicare Advantage's Growing Slice of the Pie

Nearly half of U.S. seniors enrolled in Medicare receive coverage through Medicare Advantage plans.



Source: Kaiser Family Foundation

CVS says it has already proved that vertical integration, even at a more modest scale, can lower medical costs and improve patient outcomes. It points to Aetna members in its commercial self-funded business, who it says had 3% to 6% lower medical costs a month if they were also enrolled in Caremark, and notes that Aetna members with certain conditions who filled their prescriptions at a CVS pharmacy had 6% higher drug-adherence rates.

In 2022, CVS was the fourth-largest player in the Medicare Advantage market, accounting for 11% of policies, according to the Kaiser Family Foundation. The leaders in the space remain UnitedHealth at 28% and Humana at 18%.

“We’ve been focused on this as one of our key areas of growth,” says Dan Finke, Aetna’s president.

CVS’ share has been stuck at 11% since 2020, but the overall Medicare Advantage pie is expanding. And CVS insists it has an advantage that its competitors don’t: Even after the planned closure of 900 retail stores by 2025, the company says 85% of Americans will live within 10 miles of a CVS.

On a sunny October Friday, I took a tour of CVS stores in the tri-state area, where the brand is so ubiquitous that I was able to visit eight locations spread across the New York City suburbs within a few hours.

Turns out I could have saved myself the trip. Part of what makes a CVS a CVS is the brand’s consistency. Every 30 minutes or so, I arrived at a new store and walked through an essentially identical building, with the same gray-patterned carpet, the same red-and-white signage, and the same Halloween aisle featuring the same three-foot-tall animatronic zombie butler. The company has succeeded in making the experience of navigating from its beauty section to the Tylenol aisle to the self-checkout as much a part of the shared American retail experience as pulling through a McDonald’s drive-through, or ordering a venti latte at Starbucks.

CVS’ strategy for harnessing the power of these stores has evolved over time. Early in its life as a public company, it aimed to dominate through sheer retail scale, buying up smaller drugstore chains and adding them to its growing empire.

But as the company pushed into the healthcare sphere with its 2007 acquisition of Caremark and its $70 billion deal for Aetna in 2018, the stores began to play a more strategic role. Today, more than 1,000 CVS locations have MinuteClinics, most of which exist as part of one of its more full-service HealthHUBs. These locations put CVS in a new category—caregiver—linking its health-focused and retail operations.

Now, the company is looking to tweak the use of its stores yet again, splitting them into three categories: traditional pharmacies, “enhanced versions” of the current HealthHUBS, and locations dedicated to primary care.

To fulfill that vision, CVS needs to build—or, more likely, buy—a primary-care business. That has proved to be easier said than done.

In Eastchester, N.Y., one of the CVS stores I visited sits across the street from a CityMD, an urgent-care facility owned by Summit Health, which in November was acquired for $8.9 billion by primary-care chain VillageMD. Next door is a Walgreens, owned by Walgreens Boots Alliance, VillageMD's largest shareholder. This unassuming stretch of Eastchester exemplifies the trend sweeping the industry: Everyone wants a piece of the primary- and urgent-care market.

In July, Amazon shocked the healthcare sector by announcing a $3.9 billion acquisition of One Medical, the boutique primary-care chain that trades under the name 1Life Healthcare (ONEM). Amazon has dabbled in healthcare for years, periodically freaking out healthcare investors as it dips a massive toe into the industry. This time, it appeared to have shouldered aside CVS, which was also reported to have been bidding on One Medical.

CVS owns and operates about 9,000 stores, including this one in Massachusetts. PHOTOGRAPH BY TONY LUONG

CVS shot back two months later, announcing its Signify deal. In addition to its core business of assessing home health needs, Signify recently acquired Caravan Health, which manages relationships for physicians' groups in so-called value-based arrangements, where they are compensated based on health outcomes. The deal ticks some boxes related to Lynch's strategy, but it doesn't fulfill the need to offer primary care.

J.P. Morgan's Gill says that CVS still seems to be sorting out what type of primary-care buy best fits its needs. "I think they've been trying to figure out, do you hire [medical practices] one by one and build up the strategy from a community standpoint, or do you go and buy the tech stack and buy a group of physicians, then roll that out into new markets?" she says.

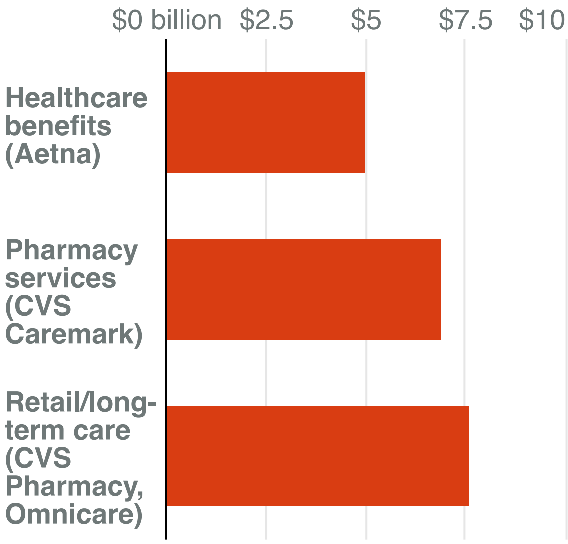
The Signify purchase may have given CVS more breathing room to work through its options. "I do think that the Signify deal in their mind provides enough [earnings] accretion by 2024 that it gets them that extra 2% to 3% of earnings growth they need, and takes some of the pressure off," says Credit Suisse's Rice.

The deal could also provide some insight into another critical question: how regulators might react to the company adding more pieces to its already sprawling healthcare portfolio. CVS has disclosed that the Department of Justice had asked for "additional information" about the Signify acquisition, extending a waiting period mandated under antitrust regulations. Lynch says that the acquisition represents an "extension" of CVS' services, and that the company isn't a direct competitor: "I'm pretty confident that we will answer their questions, and we'll get past this."

Another potential acquisition hurdle appeared in October, when the Centers for Medicare & Medicaid Services, which runs the Medicare Advantage program, surprised CVS by cutting the quality ratings of some Aetna Medicare Advantage plans.

Breaking Down CVS Earnings

Adjusted operating income by business segment in 2021



Source: company reports

The move means that CVS will miss out on expected bonus payments, worth approximately $800 million in 2024, according to a note from RBC Capital Markets analyst Ben Hendrix. Gill wrote that the contribution from the Medicare Advantage business to CVS' overall adjusted earnings per share could drop from 99 cents in 2023 to 30 cents in 2024 if the company doesn't find a way to cushion the blow.

That's a problem for CVS, which last year projected "low-double digit sustainable EPS growth" starting in 2024, 7% to 8% of which would come from its "foundational businesses." Hendrix wrote that the quality rating cuts could bring that core earnings growth down to just 4.5%.

CVS responded with a securities filing stating that it would still grow adjusted EPS at the projected rates, saying that it was considering share repurchases to offset the impact of the ratings drop.

For some observers, that sounded an alarm: Would the cost of buybacks leave the company in a position to make a major acquisition?

On an investor call a month later, CVS Chief Financial Officer Shawn Guertin said that CVS has the cash to buy back stocks and push its 2024 adjusted earnings to $9.75 to $9.95 per share. Still, he cautioned that "repurchasing shares alone will not advance the strategic positioning of the company." To advance its primary-care plan, CVS would consider pursuing both buybacks and mergers and acquisitions "for the right strategic deal," he said.

In an interview before the call, Lynch hit the same note. "We have the ability to do share repurchases, and, as we continue to look at assets, it's important for us to continue to invest in our strategy," she said.

Despite Lynch's desire to move quickly, she has repeatedly said her strategy will take a total of three to five years to execute. Meanwhile, she says, investors looking to track the company's progress should keep an eye on growth, which will show that the company is delivering on its larger plans.

"We have a clearly defined strategy," Lynch says. "We truly, as a company, have a unique set of key capabilities. We have the opportunity to transform healthcare in America, and to make it easier, to make it simple, to make it personalized, and to make it affordable."

The company's insistence that it will move forward with its strategy, including primary care, despite rising competition and continued earnings pressure, should reassure investors that Lynch is keeping those sweeping goals in her sights.

Sizing Up the Competition

CVS looks like a bargain compared with many of its rivals.

Company / Ticker	Recent F
CVS Health / CVS	$102.28
UnitedHealth Group / UNH	542.91
Humana / HUM	549.18
Cigna / CI	332.19
Elevance Health / ELV	529.90
Walgreens Boots Alliance / WBA	40.65
Walmart / WMT	149.11

*For fiscal year ended Aug. 2022 **For fiscal year ended Jan. 2022

Source: FactSet

Even with all of the recent M&A, there remain plenty of primary-care assets that could be up for grabs, including large players like Cano Health (CANO), which CVS was reportedly in talks—since ended—to acquire in October, and Oak Street Health (OSH), which has a $5.3 billion market value, as well as smaller chains like the privately held ChenMed. Analysts say CVS could find success with either end of the size spectrum.

"We don't need to see a fully formed primary-care business that CVS is acquiring," says Michael Cherny, an analyst at BofA Securities. CVS' retail and financial might are sufficient to scale up any business it buys, he says.

For investors willing to bet that Lynch's plan will come together, albeit on a longer timeline than originally hoped, the company certainly looks undervalued today.

"I think there's a lot of upside there," says Credit Suisse's Rice. "But there's also probably not very much downside, given where it's trading today."

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