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2017 Healthcare Services Preview: A Few Diamonds in the Rough

Upgrading DGX / Downgrading ABC, CAH and MCK

Summary

We are taking a fresh look at our coverage universe heading into 2017. We expect volatility in many of our stocks due to ACA repeal exposure and drug pricing exposure, both of which will likely remain divisive issues this year. As a result of this uncertainty, we are becoming more selective with our Buy-rated recommendations. We are upgrading DGX to Buy and lowering our ratings on ABC, CAH and MCK to Neutral. In addition to DGX, our other Buy-rated stocks are WBA, CVS, Q and ACHC. As a result of our rating changes, we only have five stocks rated Buy (or ~16% of our coverage universe) as we enter 2017.

Key Points

- **Upgrading DGX To Buy: Sometimes Boring Is Good.** Despite its rich valuation, we think DGX is set to outperform once again in 2017 due to good EPS visibility, no international exposure, solid balance sheet, premier capital deployment strategy and little exposure to changes in the ACA or drug pricing. Our new price target is $103.

- **Downgrades.** Since upgrading ABC and MCK to Buy, and reiterating our Buy on CAH post the outcome of the Presidential election, the drug distributor group (+10%) has outperformed the S&P 500 (+5%) and S&P 500 Healthcare (+1%) during the same time frame. To maintain Buy ratings we would need to raise our valuation multiple which we do not believe is warranted given: 1) lack of earnings nd visibility; 2) potential downside risk to guidance in the near-term due to drug pricing; 3) company-specific overhangs; and 4) valuation.

- **Price Target Changes Only.** We are increasing our price target for WBA to $94 from $90. We are lowering our price target for UHS to $115 from $133.

- **2017 Buy rated stocks.** In addition to DGX, our other Buy rated stocks are WBA, CVS, Q and ACHC. Our thesis on each stock remains largely unchanged. Despite each stock having its own individual headwind, we expect clarity on the headwinds in the near-term and, as a result, these stocks should outperform in 2017 versus other healthcare service stocks that are more leveraged to potential changes in the ACA and/or changes in drug pricing.

Company	Symbol	Price (1/02)	Rating Prior	Rating Curr	PT
AAC Holdings, Inc.	AAC	$7.24	–	Neutral	$9.00
Acadia Healthcare Company, Inc.	ACHC	$33.10	–	Buy	$45.00
Amerisource Bergen Corp.	ABC	$78.19	Buy	Neutral	$83.00
Cardinal Health, Inc.	CAH	$71.97	Buy	Neutral	$79.00
CVS Health	CVS	$78.91	–	Buy	$90.00
Diplomat Pharmacy, Inc.	DPLO	$12.60	–	Neutral	$17.00
Envision Healthcare Holdings, Inc.	EVHC	$63.29	–	Neutral	$27.00
Express Scripts Inc.	ESRX	$68.79	–	Neutral	$76.00
Laboratory Corp. of America Holdings	LH	$128.38	–	Neutral	$135.00
McKesson Corporation	MCK	$140.45	Buy	Neutral	$147.00
MEDNAX, Inc.	MD	$66.66	–	Neutral	$64.00
Quest Diagnostics Inc.	DGX	$91.90	Neutral	Buy	$103.00
Quintiles IMS Holdings, Inc.	Q	$76.05	–	Buy	$90.00
Rite Aid Corporation	RAD	$8.24	–	Buy	$9.00
Team Health Holdings Inc	TMH	$43.45	–	Neutral	$38.00
Universal Health Services Inc.	UHS	$106.38	–	Neutral	$115.00
Walgreens Boots Alliance, Inc.	WBA	$82.76	–	Buy	$94.00

Source: Bloomberg and Mizuho Securities USA

Ann Hynes
Managing Director, Americas Research
+1 617 235 1741
ann.hynes@us.mizuho-sc.com

Michael Pruell
Research Associate, Americas Research
+1 617 235 1738
Michael.Pruell@us.mizuho-sc.com

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2017 Healthcare Services Preview: A Few Diamonds in The Rough

We are taking a fresh look at our coverage universe heading into 2017. We believe uncertainty surrounding the new Trump administration combined with a conservative drug pricing environment will be overhangs for most of our sub-sectors in healthcare services in 2017. Further, we expect volatility in many of our stocks due to Affordable Care Act (ACA) exposure, which will likely remain a divisive issue at least until the new administration determines a repeal-and-replace solution. As a result of this uncertainty, we are becoming more selective with our Buy-rated recommendations. We are upgrading DGX to Buy (sometimes boring is good) and lowering our ratings on ABC, CAH and MCK to Neutral (lower confidence of stable earnings). As a result of our rating changes, we only have five stocks rated Buy (or ~16% of our coverage universe) as we enter 2017.

Rating Changes. We are upgrading **DGX** (improved EPS visibility, no international exposure, solid balance sheet) to a Buy rating and lowering our ratings on **ABC, CAH** and **MCK** (low earnings visibility, negative investor sentiment and not-so-cheap valuation) to Neutral from Buy.

Exhibit 1: Rating, Price Target And/or Estimate Changes

		Rating		Price Target		FY18 Adjusted EPS	
Company	**Ticker**	**Previous**	**New**	**Previous**	**New**	**Previous**	**New**
Quest Diagnostics	DGX	Neutral	**Buy**	$88	**$103**	No change	No change
AmerisourceBergen	ABC	Buy	**Neutral**	$83	No Change	No change	No change
Cardinal Health	CAH	Buy	**Neutral**	$79	No Change	No change	No change
McKesson	MCK	Buy	**Neutral**	$147	No Change	$12.75	**$12.15**
Walgreens Boots Alliance	WBA	Buy	No change	$90	**$94**	No change	No change
Universal Health Services	UHS	Neutral	No change	$133	**$115**	No change	No change

Source: Mizuho Securities USA, Inc. (MSUSA) estimates and company reports.

In addition to DGX, our other Buy rated stocks are WBA, CVS, Q and ACHC. Our thesis on each stock remains largely unchanged. Despite each stock having its own individual headwind, we expect clarity on the headwinds in the near-term and, as a result, we believe these stocks should outperform in 2017 versus other healthcare service stocks that are more leveraged to potential changes in the ACA and/or changes in drug pricing. We remain Neutral on UHS, ESRX, DPLO, LH, EVHC, MD, TMH and AAC. For UHS, we are reducing our price target from $133 to $115 driven by a lower multiple for the behavioral segment (9.0x versus our previous EV/EBITDA multiple of 10.5x) in our sum-of-the parts valuation method. Given the overhang and increased scrutiny on its behavioral admission coding practices, we no longer believe UHS can trade at the higher multiple.

Healthcare Stocks Historically Underperform When There No Balance of Power in Washington. Below we highlight previously published data on price performance of the S&P 500 Healthcare Index, S&P 500 Healthcare Equipment & Services Index, the S&P 500 Pharmaceutical, Biotech and Life Sciences Index versus the S&P 500 after a Presidential election. Bottom line: one party control in Washington equals underperformance for healthcare stocks. When there is no joint control in Washington with one party controlling the Executive and Legislative branches, the S&P 500 Healthcare underperformed the S&P 500 post–election (+2% versus +10%) on average. Note that this performance is independent of which party controls Congress: whether control is in the hands of either the Democrats or Republicans; the health care index underperformed the S&P 500.

Exhibit 2: Stock Market Performance Post Presidential Election Years

	1992 Pre Election	1992 Post Election	1996 Pre Election	1996 Post Election	2000 Pre Election	2000 Post Election	2004 Pre Election	2004 Post Election	2008 Pre Election	2008 Post Election	2012 Pre Election	2012 Post Election
S&P 500 Healthcare Index	(18%)	(12%)	+18%	+31%	+28%	(8%)	(8%)	+9%	(22%)	+9%	+14%	+33%
S&P 500 Healthcare Equipment & Services	(17%)	(11%)	+6%	+12%	+48%	(8%)	+3%	+24%	(33%)	+14%	+13%	+29%
S&P 500 Pharma, Biotech & Life Sciences	(18%)	(12%)	+22%	+37%	+23%	(7%)	(13%)	(2%)	(16%)	+7%	+15%	+35%
S&P 500 Index	+1%	+10%	+15%	+29%	(3%)	(22%)	+2%	+7%	(32%)	+12%	+12%	+25%

	Average All Elections		Balance Of Power		No Balance Of Power	
	Pre	Post	Pre	Post	Pre	Post
S&P 500 Healthcare Index	**+2%**	**+10%**	**+4%**	**+19%**	**(8%)**	**+2%**
S&P 500 Healthcare Equipment & Services	+3%	+10%	+3%	+11%	+3%	+9%
S&P 500 Pharma, Biotech & Life Sciences	+2%	+10%	+5%	+22%	(13%)	(2%)
S&P 500 Index	**(1%)**	**+10%**	**(1%)**	**+11%**	**+2%**	**+10%**

-Pre the 1992, 1996, 2000, 2008 and 2012 elections there was a balance of power in Washington
-Post the 1996, 2000, and 2012 elections there was a balance of power in Washington
- Pre the 2004 election no balance of power
- Post the 1992, 2004 and 2008 elections there was no balance of power in Washington

Source: Mizuho Securities USA estimates and Bloomberg. *Pre-election is performance January 1st to election date. Post-election is performance 12 months' post-election date.

Upgrading DGX to Buy from Neutral: Sometimes Boring Is Good

We are upgrading Quest Diagnostics (DGX) shares to a Buy rating from Neutral and raising our price target to $103 from $88. We downgraded DGX from Buy to Neutral on 8/31/16 due to valuation given DGX (+26%) had outperformed the S&P 500 Healthcare (+10%) since we upgraded the stock on 3/1/16. Further, we expected investors' appetite for risk to potentially increase after the presidential election and expected DGX to be used as a source of funds given its outperformance and high valuation. Given the outcome of the Presidential election, we no longer believe this thesis is valid. More importantly, we believe DGX has little exposure to potential negative changes to the ACA as hospitals likely benefited from incremental lab volume associated with expansion under Obamacare.

Our new price target of $103 is based on a blended valuation, averaging our implied price target based on forward PE (no change to our 16.4x multiple) and free cash flow (we are now using a 5% FCF yield versus 6% previously). Given the company's strong balance sheet, capital deployment strategy and high dividend yield, we believe DGX deserves to trade a 5% FCF yield versus other healthcare services companies. Further, we believe the company will continue to outperform in 2017 largely due to its enhanced visibility in reaching its long-term 2017-2020 guidance and its stable earnings results. We think DGX's consistent track record and ability to execute is

attractive in a challenging healthcare services environment and will be appealing to investors. Additionally, we think the company will drive upside with: 1) continued execution of its Invigorate savings; 2) solid free cash flow and balance sheet trends; 3) high dividend yield of +2%; 4) lack of international exposure; and 5) little exposure to changes to ACA repeal and replace.

Growth Assumptions Look Achievable. At its Investor Day in November, DGX raised its long-term 2017-2020 revenue outlook to +3-5% from +2-5% previously and expects earnings for the same period to grow in the mid-to-high single digit range. The anticipated +3-5% growth does not include share repurchase or other capital deployment assumptions with the exception of +1-2% growth from M&A. The company believes this type of growth is achievable by increasing the number of partnerships with other health care leaders while improving the patient experience and reducing the overall cost of care. DGX expects it can significantly decrease its costs through its Invigorate program which is on pace to generate $1.1bn in run rate savings by the end of 2016 and $1.3bn in savings by the end of 2017. By forming joint ventures with hospitals and health care systems, we believe DGX can further reduce costs through economies of scale and the routine nature of these tests.

Hospitals an area for growth. We believe a key area for growth is in hospital and health systems as they are under significant cost pressure and have the desire to partner with clinical laboratories. Hospitals represent roughly 60%, or $48bn, of the total addressable market with $27bn related to inpatient, $17bn in hospital outreach, and $4bn in reference testing. For DGX, this presents an opportunity to form a partnership so these hospitals and health systems are able to outsource low volume, high cost testing to DGX labs. This enables hospitals to decrease staffing needs, free up space, and improve turnaround time. Additionally, a partnership with DGX would enable the hospital to make purchases on discounted DGX contracts, which would reduce the costs of supplies, etc. For DGX, these relationships are also very beneficial. Due to significant economies of scale in the lab business as well as the fact that many of these outsourced tests are routine in nature, DGX has very low costs associated with these hospital collaborations. The company estimates that it avoids around 20% of its costs when it forms a hospital joint venture and as a result finds these relationships very attractive. DGX currently has more joint ventures than anyone else in the industry and we believe the company will continue to add JVs. DGX currently offers several levels of hospital system business solutions, ranging from basic reference testing to fully outsourced professional lab services options. In 2016, DGX increased visibility into its hospitalization strategy by announcing that it would manage laboratory operations for six Denver-area HealthOne hospitals owned by HCA in addition to its partnership with Barnabas Health in New Jersey. We believe that hospital / lab JV's are mutually attractive and that hospitals save 10-20% of lab costs associated with the DRG (which is a cost center for the hospital). We believe DGX will be able to expand its partnership to HCA hospitals in other regions, and likely with additional hospitals. We believe hospitals will continue to shift towards outsourcing and as a result expect additional JV announcements from

DGX going forward. Our model does not include unannounced JVs given the length of time (6 months to one year) to close one of these deals.

Lean Operation and Cost Savings a Continued Focus. DGX remains committed to its strategy to remove unnecessary costs out of the company's highly levered infrastructure. The company's Invigorate plan is on pace to generate $1.1bn in run rate savings by the end of 2016 and $1.3bn in savings by the end of 2017. We would not be surprised if the company increases this goal at some juncture in 2017.

Retail Opportunity Could Expand. DGX plans to increase its presence in Safeway stores to more than 50 by end of 2016 and 200 by end of 2017 and is looking to partner with other retailers as well. Typically, when the company opens a retail location they close an existing location, making it a one-for-one transaction, but this is not always the case. Additionally, DGX expects it will be able to offer direct access testing in two states by the end of 2016. We expect more announcements of retail partnerships in the coming years.

Sound Capital Deployment Strategy. We expect DGX to continue to deploy capital back to shareholders via share repurchase, dividends and accretive M&A. Since 2012, DGX has generated roughly $5bn in CFFO and has redeployed the cash in an efficient and diverse manner. Of the $5bn, the company had $2bn in share repurchases, $1bn in dividends, $1bn in capital expenditures and $1bn in M&A. Returning cash to shareholders has been a clear priority as the company has used roughly 60% of the $5bn since 2012 on share repurchases and dividends. We expect this will remain a priority as the company recently announced it is increasing its quarterly dividend (for the sixth time since 2011) by 12.5% to $0.45 per share from $0.40 per share. Additionally, the company has invested approximately $1 billion in 10 acquisitions since 2012 and we expect DGX will continue to grow through their disciplined acquisition approach. Long-term guidance assumes a +1% to +2% contribution from M&A, and we expect the company to continue to focus on tuck-in acquisitions including small regional labs and outreach centers.

Cross Roads with Distributors: Downgrading Group to Neutral

We are downgrading ABC, CAH and MCK to Neutral from Buy while maintaining our price targets of $83, $79 and $147, respectively. Since upgrading ABC and MCK to Buy, and reiterating our Buy on CAH post the outcome of the Presidential election, the drug distributor group (+10%) has outperformed the S&P 500 (+5%) and S&P 500 Healthcare (+1%) during the same time frame. To maintain Buy ratings we would need to raise our valuation multiple which we do not believe is warranted given: 1) lack of earnings visibility; 2) potential downside risk to guidance in the near-term due to drug pricing; 3) company-specific overhangs; and 4) valuation. Our Buy ratings were based on the thesis that the pricing environment would likely stabilize post the outcome of the election however we have reduced confidence that this is still the case in the near-term. As a result, we think the risk reward is

unattractive at current valuation levels as the group is trading at 14.5x, slightly above the mid-range of the drug distributor 10-year trading average of 14.2x.

Exhibit 3: Price Performance Post Election

Company	Ticker	Rating		Price	Performance	Price	Impllied
		Previous	New	12/31/16	Since Election	Target	Valuation Multiple
AmerisourceBergen	ABC	Buy	Neutral	$78.19	+13%	$83	15.4x
Cardinal Health	CAH	Buy	Neutral	71.97	+10%	79	14.2x
McKesson	MCK	Buy	Neutral	140.45	+8%	147	13.9x
Average					**+10%**		**14.5x**
Index							
S&P 500				$2,238.83	**+5%**		
S&P 500 HC				796.91	**+1%**		

Source: Company reports and MSUSA estimates.

Company specific headwinds include contract renewal (Express Scripts and potentially Humana) for ABC, noisy earnings for MCK in FY18 related to the Change Healthcare spin-out and likely roll-off of the RAD contract (it is unclear what consensus estimates reflect and whether or not MCK provides some sort of early guidance for FY18 given all the moving parts) and lastly, in its medical segment, CAH is negatively leveraged to any potential changes to the ACA.

Pricing Volatility Likely a Valuation Overhang for Early 2017. We had hoped that the outcome of the Presidential election would result in more stable pricing by both the brand and generic manufacturers; however, we have reduced confidence in this thesis two months out from the election. Channel checks suggest drug manufacturers remain concerned about pricing, mainly because the industry does not know what to expect from President-elect Trump's administration. The industry knew what to expect post a Clinton win and was prepared for that outcome, but the industry still does not know what to expect from Trump, given that he is an outsider and drug pricing was not a major issue in his campaign. We believe the pricing increases taken by the drug industry in January will be telling of industry behavior in calendar 1H:17 and, given the uncertainty with Trump administration, coupled with recent launched federal investigations into certain brand and generic manufactures, we think there is an increased risk that price increases taken by the industry in January could be lower than the recent trends of high-single digits until the industry has greater clarity on the Trump administrations' views on the drug industry. Based on conversations with the drug distributors, guidance is typically updated based on the drug industry's January and July pricing increases. As result, we believe there is near term downside risk to ABC's, CAH's and MCK's brand price inflation/generic deflation assumptions as the drug distributors will likely have to update guidance based on the January pricing behavior from the manufactures. Given this phenomenon, we believe earnings visibility is reduced going forward, at least for the first six months of calendar 2017. We will re-evaluate our opinion on the distributors as we see the politics play out

given a positive stance in Washington could lead to an acceleration in pricing trends in the second half of 2017 post the July pricing hikes.

Exhibit 4: Pricing Assumptions Embedded in Guidance

		Pricing Assumption	
Company	**Ticker**	**Brand Inflation**	**Generic Deflation**
AmerisourceBergen	ABC	7-9% inflation	7-9% deflation
Cardinal Health	CAH	7-9% inflation	mid-to-high single digit deflation
McKesson	MCK	Meaningfully below those experienced in FY16	No quantitative guidance provided; we believe similar range as ABC and CAH

Source: Company reports and MSUSA estimates.

Besides low EPS visibility due to pricing factors, each drug distributor has a company-specific headwind that could be an overhang in 1H:17.

ABC- Major Contract Renewals Will Likely Put a Cap on Multiples in The Near-Term. ABC faces an overhang from the renewal of its ESRX contract, which is set to expire September 2017. Express Scripts is ABC's second largest customer, accounting for roughly 16% of revenue and 10% of its accounts receivable. Given Express Scripts is a large client, we suspect the EPS contribution is much lower, only accounting for an estimated 5% of annual ABC Adjusted EPS, or ~$0.30. We ultimately believe ABC will renew the contract in FY17 but sizeable contracts like this always remain an overhang until officially renewed. Also, at some point over the next 12-months, we think ABC will need to renew the Humana contract, but exact timing and revenue impact is unclear. We think the timing and outcome will depend if the Humana/Aetna deal is ultimately approved. In a conference call earlier this year ABC noted that its assumption for 2017 is that it will retain Humana's business. On the positive side, we think the WBA/RAD merger will provide upside to our estimates. Our estimates do not include the potential gaining of the RAD business via its relationship with WBA, which could add +$0.19-$0.29 to annual EPS (or +3-5% to annual EPS).

CAH-Negatively Leveraged to Potential Obamacare Changes. On the positive side, CAH stands to benefit from the recent sale of 865 RAD stores to Fred's (FRED, not covered) as CAH is the company's wholesaler. However, we think the rhetoric from Washington on the potential repeal and replace of Obamacare could serve as a valuation overhang given the company's medical segment, which accounts for roughly 16% of profit, would be negatively leveraged to any changes to this entitlement program. This, coupled with pricing pressures in its drug distribution business, reduces EPS visibility going forward.

MCK-FY18 EPS Looks Noisy Due to the Likely Roll-Off of the RAD Contract, the Spin-Out of Change Healthcare and Industry Consolidation Headwind. We

still worry about the negative impact further industry consolidation has on MCK. Aetna uses MCK as its distributor while Humana uses ABC, so the combined insurer would likely restructure its relationships and shift volume from one of the companies to the other. Our MCK FY18E estimates already assumed the entire loss of the RAD contract, which we estimate in the range of $0.80-$0.90. MCK was hoping to retain at least some of its business with these stores but since the stores were sold to Fred’s (CAH is Fred’s wholesaler) we think this is unlikely. We are reducing our MCK adjusted EPS estimates for FY18 by $0.60 for negative impact of the spin-out of Change Healthcare. Both our RAD estimates and Change Healthcare estimates are assumptions at best given the limited guidance provided by MCK on each headwind. Given all the moving parts, we hope MCK provides some clarity on FY18E guidance earlier than its usual time frame of May as we fear all the moving parts will remain a valuation overhang.

Reiterating Buy on WBA

We are reiterating our Buy rating on Walgreens Boots Alliance (WBA) heading into 2017 given our favorable long-term outlook on the stock. Our positive view is based on: 1) increasing volumes resulting from the company’s preferred network arrangements; 2) the ability to leverage this increased store traffic into higher front-store sales and margins; 3) confidence the Federal Trade Commission (FTC) will approve the pending acquisition of RAD; and 4) more upside potential to annual EPS than downside risk. Having said that, we do caution investors that there will likely be some noise in first half fiscal 2017 results. We expect recently announced strategic partnerships will weigh on margins and expect brand pricing weakness and currency impacts to drive revenue lower than consensus when the company reports FQ1:17 this coming Thursday. Ultimately, we would view any noise as short term. Our new price target of $94 versus $90 is driven by an increase in our free cash flow estimates for the stand-alone WBA. Our price target or estimates do not include the pending acquisition of RAD, which we will include once official FTC approval is won.

Creative Partnerships to Win Back Market Share. We think WBA is positioned well as the company has established a strong pharmacy network in recent months. Specifically, the company has strengthened its relationship with ESRX, OptumRx, UNH, and Prime Therapeutics, which is consistent with the company's previously stated goal of increasing partnerships. We view the deals as positive for WBA as it will bring incremental volume to WBA pharmacies (we suspect by F2H:17) and as a result could bring an uptick in front-store sales. While the incremental volume will likely be offset with lower reimbursement rates, we think this is a sound strategy given prior management negotiating strategies negatively impacted market share. Additionally, we view the specific deals as good business because they are with high-quality companies.

We remain confident in FTC approval of RAD deal. Although the anticipated timing of RAD approval has been pushed back, we are increasingly confident that WBA will receive successful FTC approval. During its F4Q:16 earnings release, WBA announced an extension of the RAD merger agreement from the end of

calendar year 2016 to early calendar year 2017. More importantly though, Fred's (FRED, not covered) announced on December 20, 2016 that it signed an agreement with WBA and RAD to purchase 865 stores and other assets for $950M in cash. We think the sale to Fred's should remove any FTC concerns for the completion of the WBA/RAD acquisition given the acquirer is a legitimate buyer that has experience running pharmacies. We believe the FTC was most concerned that the buyer of the stores was a real buyer with a solid track record and Fred's fits this description. Fred's will become the third largest drugstore chain in the US after the completion of the deal, so we do not anticipate any FTC related headwinds.

Upside potential to annual EPS. We think our adjusted EPS has more upside potential than downside risk. Our FY17E adjusted EPS is $5.00 (versus consensus of $5.02) and FY18E is $5.50 (versus consensus of $5.61). It is important to note that our estimates reflect a stand-alone WBA, excluding the benefit of RAD which the company estimates could be $0.05-$0.12 accretive for FY17E. Depending on the timing of the close of the transaction (WBA FY17 began September 1, 2016 and FTC approval is expected early in calendar 2017) and the timing of the expected $1bn of synergies, we estimate the RAD acquisition could add up to $0.12E in FY17E and $0.30E in FY18E. Additionally, our proforma RAD estimates do not include any refinancing of RAD's high-cost debt. At the end of F2Q17, RAD had $7.22b in debt including $3.5b in senior notes with interest rates greater than 6%. Certain RAD notes contain strict prepayment penalties and we are unsure the near-term ability for WBA to reduce RAD's debt. However, we believe WBA should be able to reduce and refinance some portions of RAD's debt, which could add upside to our estimates. We believe that WBA can leverage its increased store traffic from restricted network agreements into higher front-store sales and margins. We think FY18E adjusted EPS had even more upside potential given the expected increase in volume from recent network agreements.

FQ1:17 could be noisy. Despite our favorable long-term outlook, we do expect some noise in the first half of fiscal 2017. We anticipate earnings will be back half weighted as the new partnerships ramp up. Further, until the volume ramps ups, we expect gross margins to decline given the volume was likely won on lower margin. As volume builds, we expect WBA to post strong operating leverage from the increased volume. The majority of its recently announced strategic partnerships, which come into effect on day one of the contracts, will begin in the early part of CY17 with the exception of Tricare, which the company expects to contribute effective December 1st. As a result, we expect to see a bump in gross profit dollars due to increased traffic but also anticipate declining gross margins.

Our F1Q:17 and F2Q:17 adjusted EPS estimates of $1.04E and $1.34E are lower than consensus of $1.09 and $1.39, respectively. We estimate revenue of to be lower versus consensus in the first half of the fiscal year (we estimate $29.15bn and $30.44bn versus consensus of $29.27bn and $31.22bn for F1Q and F2Q) largely due to weak brand inflation and a modestly negative impact from currency. While weaker brand inflation should not impact profitability much given WBA is roughly 85%

generics, we think it will have a negative impact on revenue due to brand drugs' higher price. In terms of currency, FY17 guidance is currently based on the exchange rates from last quarter's release date, October 20, 2016. While the GBP:USD rate (GBP accounts for roughly 12.0% of sales) has improved to $1.23 from $1.22 since then, the EUR:USD rate (EUR accounts for roughly 14.3% of sales) has declined to $1.05 from $1.09. Overall, we expect the currency impact for F1Q:17 to be modestly negative and think this could continue to be a headwind moving forward.

Reiterating Buy on CVS

We are reiterating our Buy rating on CVS Health Corporation (CVS) heading into 2017. Our positive view is based on: 1) good long-term earnings visibility; 2) growth opportunities from generic approvals and specialty business; 3) the company's streamlining initiative; 4) sound capital deployment; and 5) limited international exposure. While we do expect the renewal of the FEP specialty contract to remain an overhang for the stock, we are confident the company will renew given its strong track record and client retention rate of ~97%. Given its cheap valuation (13.4x 2017 versus the group's 10-year average of 15.1x), we think CVS is a good stock for a long-term value investor.

Earnings Expectations Reset, Risk Removed. At its investor day in December, CVS reaffirmed its 10% long term adjusted EPS growth which the company expects will be driven by 11% revenue growth, operating profit growth of roughly 5% and a 5% contribution from share repurchases (generated by $7-8B in annul cash available). While the forward-looking EPS growth expectation is below the company's 2013-2016E CAGR of 14%, we do not view this as surprising given continued reimbursement pressure, the law of large numbers and, most importantly, the subsiding brand-to-generic cycle, which was a meaningful driver of growth for the supply chain for most of the last decade. We think the company has good earnings visibility as they have several opportunities for growth including: 1) partnering more broadly; 2) introducing innovative PBM products; 3) introducing its streamlining initiative; and 4) returning value to shareholders.

We expect CVS to be a Net Winner in the PBM Market. Despite increased PBM competition, CVS won greater than 50% of revenue from clients changing PBMs in 2017 selling season and added $7.8B of gross new business for 2017 that included $1.4bn from employers, $5.1bn from health plans and $1.3bn from government & union. The company added $4.3bn in net new business and boasted a client retention rate of ~97%. Although the PBM competitive environment is more challenging today than it was over the past five years given Optum is now a formidable competitive, coupled with ESRX emerging from its problems under new leadership, we expect CVS to remain competitive and be a net winner going forward. We expect CVS to introduce new product offerings in the PBM selling season for 2018 start dates, which heats up in April. Given its retail network, we would not be surprised to see CVS introduce more PBM products with restrictive retail networks.

Increase in generic approvals could be an opportunity. We view the potential approval of generic backlog as a potential source of upside to our estimates despite the benefit from break-open generics expected to slow in the coming years. The backlog for generic approvals is currently 4,036 which we think creates an opportunity for CVS and, more importantly, President-elect Trump has mentioned potential FDA reforms as an area of focus for the administration. We expect there to be an increased effort to bring generics to market more quickly given the desire for lower prices and as a result we think CVS is poised to benefit. In addition, biosimilars also add additional upside and CVS estimates that biosimilars could add $5.7B in revenue in 2017E.

Specialty still a driver. In 2017, the company expects specialty revenue to be $59bn. As the complexity of patients continues to increase and the specialty market requires broader solutions, the company's integrated model enables it to meet the needs of the specialty market through faster turnaround times, specialized patient support and a reliable, convenient dispensing network that reduce shipping times and costs. Furthermore, the PBM aligned specialty pharmacy works as part of a larger relationship that better suits the client by reducing costs and offering convenient locations. According to CVS, costs are 250bps lower when a client used the CVS integrated approach compared when pairing CVS Caremark with other specialty pharmacies. Overall, the company estimates it reduces specialty drug spend by ~11%. By offering convenient locations to its customers, CVS again differentiates itself in the specialty pharmacy industry which is significant as 30% of new starts are retail and 54% of Specialty connect users prefer to pick up at CVS pharmacy. While cost management services are still ongoing, we believe formulary management opportunities should increase as more biosimilars come to market and cost pressures drive increased utilization of lower cost sites of care. We view specialty as a likely target area for strategic acquisitions going forward.

Streamlining initiative to maximize efficiency. CVS expects its streamlining initiative will maximize efficiency through: 1) store rationalization; 2) enhanced efficiency of shared services; and 3) optimized pharmacy delivery platform. Through store rationalization, CVS aims to trim its store base and close 70 stores while continuing to provide convenient local access. Additionally, the company intends to consolidate similar activities across business units. CVS stated that consolidation has already produced some promising results by reducing labor costs by as much as 15-20%. Thirdly, CVS plans to optimize its pharmacy delivery platform by using redesign and technology to maximize script fulfillment capacity. CVS estimates the initiative will drive annual savings of $700-750mm and expects aggregate savings to total nearly $3B from 2017-2021. The savings are expected to come 2/3 from Retail/LTC (because it is more capital intensive) and 1/3 from its PBM. Savings from the program are expected to exceed costs starting in 2018.

Capital Deployment. CVS estimates it will generate $7-8B in cash available for enhancing shareholder value annually post 2017, which it expects to deploy through dividends (target payout ratio of 35% by 2018), value enhancing projects, and share

repurchases ($5B per year). From 2014-2016E, CVS deployed $32B in cash available in the form of dividends ($5B), M&A ($14B) and share repurchases ($13B). We expect CVS will continue to focus on the same areas to drive growth but expect share repurchases to be a bigger part of their deployment strategy. The company is committed to return to 2.7x leverage ratio driven primarily but EBITDA growth and debt repayments. The company's current ratio of 3.02x is largely the result of a modified debt structure in order to take advantage of favorable interest rates. The company recently increased its annual dividend by +18% to $2.00 per share, up $0.30 per share over 2016. In addition, CVS now has more than $18B authorized to be used for share repurchases over the next few years.

Specialty FEP contract near-term investment risk. The specialty portion of Federal Employee Program (FEP) contract, which is up for renewal in early 2017 for a 1/1/18 is a near-term overhang for the stock. We hope to have visibility on a successful renewal by February. As a reminder, the FEP contract is divided into three segments – retail, mail and specialty. CVS serves all three components. Historically, PBM bid for the contract as an integrated contract (to include all three services) or each portion separately. CVS previously won each portion separately. The specialty contract has a request for information in the marketplace for January 2018. The FEP retail and mail order businesses, which compromise more than 70% of total FEP revenues of around $9bn, have already been extended through January 2019. We estimate the specialty portion of FEP accounts for an estimate $0.10-$0.13 or ~1.5%-2% of adjusted EPS.

Reiterating Buy on ACHC

We are reiterating our Buy rating on ACHC. Our positive view is based on: 1) conclusion of the CMA overhang; 2) favorable industry backdrop; 3) redeployment of Priory assets into the US; 4) de novo headwinds dissipating in 2017; and 5) no exposure to the potential repeal of the ACA. The only near-term risk to the stock is 2017 consensus estimates. Post 3Q earnings, we reduced and de-risked our estimates for 2017 given all the moving parts with the timing of re-deploying the proceeds of the Priory assets back into the U.S. Our adjusted EPS estimate for 2017E is $2.46, versus current Street consensus of $2.61. Although consensus estimates have been trickling down throughout the month of December, we still think there is downside to many sell-side estimates who have not properly accounted for the moving parts in there model. We would not be surprised if ACHC provides some initial 2017 guidance early to remove this overhang and reduce the confusion heading into official guidance in February. Once this event occurs, we think ACHC will get back on track in 2017, which should enable investors to refocus on the positive fundamentals of the business.

Execution Needed to Regain Investor Support. We suspect there is investor concern surrounding 2017E consensus estimates, which currently are $2.61. We view our $2.46E estimate as very conservative and assume no improvement in current same-store revenue trends, which is likely conservative. We believe 2017 guidance will be an important announcement, but even more importantly think ACHC needs to

execute and deliver a strong performance in 2017 to regain investor confidence. The company currently expects high single digit same-store growth in FY17 driven by expansionary beds in the U.S. as well as new facility growth from the redeployment of assets from Priory ($390mm expected to be redeployed in 1H17) and by joining with other partners to form joint ventures. We continue to believe that the underlying fundamentals in the behavioral industry have not changed and think ACHC is well positioned to deliver a strong FY17, but we do not expect the company to gain traction from investors until the results are produced.

Conclusion of CMA Process. In November, the CMA accepted ACHC's proposal to sell 21 Partnerships in Care and Priory hospitals and one unopened hospital site to BC Partners in order to remedy competition concerns arising out of its merger with Priory Group. The CMA received no objections to its proposed remedy, or to BC Partners as a proposed purchaser of these hospitals, which means the merger will not be referred for a phase 2 investigation. Now that the CMA overhang has come to a conclusion, we think investors can refocus on the fact that ACHC is a well-run business, with a solid industry back-drop that boasts strong growth prospects and cash flow characteristics.

Favorable Industry Backdrop. The industry backdrop in the U.S. remains favorable due to demographic and legislative tailwinds that will likely provide steady underlying admissions growth. Advances in the awareness of mental health disorders and improvements in the diagnosis and treatment of these conditions are expected to serve as key volume drivers. While President-elect Trump has yet to give specific plans on how to address the problem, Trump has mentioned the need to address mental healthcare as part of his larger health care strategy. In Trump's position on second amendment rights he makes his views clearer by stating he aims to fix the broken mental health system. He goes on to state that *"All of the tragic mass murders that occurred in the past several years have something in common – there were red flags that were ignored. We can't allow that to continue. We must expand treatment programs, and reform the laws to make it easier to take preventive action to save innocent lives. Most people with mental health problems are not violent, but just need help, and these reforms will help everyone."* Further, our adjusted EPS estimates do not include any potential benefit from IMD. We estimate the IMD modification could add $20-$29mm or $0.16-$0.22 annual adjusted EPS based on our analysis.

Redeployment of Assets. We would remind you that U.K. operations should become significantly less over the next 12 months with CMA divestitures and redeployment of capital back in the U.S. The company believes divestitures will bring the revenue mix down and upon reinvestment in early 2017 in the U.S. the UK exposure will be around 30% or below. Moving forward ACHC sees more growth back in the U.S., and ultimately, we expect a business mix of around 75% U.S. and 25% UK in about a year. This will reduce exposure to the volatile pound and allow ACHC to get back on track in the U.S.

De Novo Headwind Should Dissipate. De novo facilities have not ramped up as fast as expected (two of the four were in the same-store calculation as the facilities have been open for more than a year), contributing to slower overall as well as same-store growth. The company has four de novo facilities that have contributed to the problem largely due to issues surrounding regulatory approval at the state, city and county level. As an example, ACHC noted that its San Jose de novo facility took six months to receive regulatory approval (in October), which was significantly longer than expected. ACHC expects all four de novo should improve same-store results in 2017 as the facilities now all have received the required regulatory approvals. The company stated it will not have any new de novo facilities coming online until 3Q:17, suggesting the majority of beds added in 2017 will be expansionary in existing facilities. Our 2017E estimates assume 300 new beds in the U.S.

Our estimates have upside potential. We believe the biggest concern for ACHC is that 2017E sell side consensus estimates are at risk. Our 2017E is $2.46 versus consensus $2.61. While we believe the company is in jeopardy of missing 2017E for timing factors, we also think this risk is likely already accounted for in ACHC's current valuation. We believe that our estimates have a high level of conservatism given that our model does not include:

- Any improvement in the GBP of 1.22 when we reduced our estimates;
- Any deployment of the Priory proceeds as we prefer to wait given the lack of clarity on the type of business (e.g. inpatient versus RTC) and timing;
- Any benefit from IMD;
- Other unannounced acquisitions or;
- Any improvement in current same-store trends in the U.S. or the U.K.

That being said, ACHC does not include unannounced acquisitions in guidance. We suspect several sell-side estimates have acquisition activity for the divested Priory assets. We view this as a timing issue. We think the company will need to execute throughout 2017 in order to regain investor confidence but given the strong fundamentals in the behavioral industry we think ACHC is positioned well to do so and risk reward is attractive at current levels. ACHC currently trades at 10.4x our 2017 EV/EBITDA, lower than its four-year trading average of 14.0x.

Reiterating Buy on Q

We are reiterating our Buy rating on Q. We believe the company possesses a competitive advantage in the CRO industry with IMS's breadth of data and technological capabilities at its fingertips. While we view 2017 guidance as a key event for the stock as it will provide more clarity post the merger with IMS, we expect Q to increase market share in the CRO space which could be a driver of meaningful upside going forward.

Good EPS visibility. Our 2017E and 2018E adjusted EPS of $4.40 and $5.50 assumes +6-7% revenue and +8-10% of adjusted EBITDA growth, annually. Our 2017E and 2018E assume an incremental~$35mm and $95mm of the expected $200mm of cost synergies expected and no revenue synergies, which could prove conservative given our belief believe the company's enhanced offerings will enable it to increase market share in the CRO space and could be a driver of meaningful upside going forward. Q currently has 14% of market share and we estimate that every 1% of additional market share the company adds will translate to roughly $250mm in additional revenue.

Model should be a competitive advantage over-time. Q's operating model offers steady earnings growth driven by a favorable industry outlook and expected synergies from the merger. We expect Q to take market share in the CRO market which is expected to grow by 6-8% CAGR over the next several years. The company expects the merger will accelerate revenue growth by 100-200bps to the combined annual growth rate by the end of year three and expects to achieve annual run-rate cost savings of $200mm by 2019, resulting primarily from the reduction in corporate SG&A as well as procurement, professional services and real estate consolidation.

Solid management team should dissipate investor concerns. Post our December initiation ("Data-centric Merged Company a Compelling Story: Initiating with Buy Rating"), we received some push back from investors surrounding the departure of former Quintiles CEO Tom Pike. While we think the company will miss his leadership, we remain confident that the integration will continue to go smoothly with Richard Staub now leading the company's CRO division. More importantly, being a legacy IMS analyst, we think Ari Bousbib is an underappreciated leader and visionary who can deliver strong results. Overall, we think this is a very solid management team.

Exhibit 5: MCK Income Statement, FY16-FY18E ($mm)

	FY16					FY17E					FY18E				
	Q1	Q2	Q3	Q4	Year	Q1A	Q2A	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year
Distribution Solutions Revenue	$46,810	$48,040	$47,205	$45,944	$187,999	$49,009	$49,277	$49,961	$48,628	$196,876	$48,956	$49,239	$49,970	$48,555	$196,719
Technology Solutions Revenue	736	721	694	734	2,885	724	680	666	705	2,775	202	158	144	182	686
Total Revenue	$47,546	$48,761	$47,899	$46,678	$190,884	$49,733	$49,957	$50,628	$49,333	$199,651	$49,157	$49,397	$50,114	$48,737	$197,405
Cost of Sales	$44,757	$45,917	$45,044	$43,800	$179,518	$46,968	$47,202	$47,833	$46,496	$188,499	$46,557	$46,784	$47,468	$46,169	$186,977
Gross Profit	$2,789	$2,844	$2,855	$2,878	$11,366	$2,765	$2,755	$2,795	$2,837	$11,151	$2,600	$2,613	$2,646	$2,568	$10,428
SG&A	$1,968	$1,941	$1,952	$1,909	$7,770	$1,895	$1,855	$1,909	$1,856	$7,515	$1,893	$1,872	$1,914	$1,869	$7,548
Operating Income (EBIT)	$821	$903	$903	$969	$3,596	$870	$900	$886	$980	$3,636	$708	$741	$732	$699	$2,880
Other income (expense)	$13	$17	$13	$15	$58	$23	$24	$11	$17	$75	$124	$126	$120	$126	$495
Interest Expense	89	91	87	86	353	79	78	76	71	304	62	58	58	58	236
Pretax Income	$745	$829	$829	$898	$3,301	$814	$846	$821	$926	$3,407	$770	$809	$793	$767	$3,139
Income Taxes	223	251	218	265	957	193	214	250	282	939	212	222	218	211	863
Income From Continuing Ops	522	578	611	633	2,344	621	632	571	644	2,468	558	586	575	556	2,276
Non-Controlling Interest	13	13	13	13	52	18	17	11	11	56	11	11	11	11	44
Net Income continuing operations	$509	$565	$598	$619	$2,292	$604	$615	$560	$633	$2,411	$547	$575	$564	$545	$2,232
Diluted EPS Continuing Operations	$2.17	$2.40	$2.58	$2.70	$9.85	$2.65	$2.70	$2.50	$2.83	$10.68	$2.54	$2.67	$2.63	$2.56	$10.41
Acquisition-related amortization	0.33	0.31	0.32	0.30	1.27	0.35	0.36	0.34	0.30	1.35	0.39	0.39	0.37	0.33	1.47
MSUSA Adjusted EPS	**$2.49**	**$2.72**	**$2.90**	**$3.01**	**$11.12**	**$2.99**	**$3.06**	**$2.84**	**$3.13**	**$12.02**	**$2.93**	**$3.06**	**$3.00**	**$2.89**	**$11.88**
LIFO adjustment	0.23	0.24	0.09	0.08	0.64	0.12	(0.12)	0.03	0.06	0.10	0.07	0.07	0.07	0.07	0.27
Acquisition-related expenses (ongoing)	0.08	0.10	0.06	0.09	0.34	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Other one-items not adjusted by MSUSA	0.33	0.25	0.13	(0.73)	(0.02)	0.38	0.00	0.00	0.00	0.38	0.00	0.00	0.00	0.00	0.00
MCK Adjusted EPS	**$3.14**	**$3.31**	**$3.18**	**$2.44**	**$12.07**	**$3.50**	**$2.94**	**$2.87**	**$3.19**	**$12.50**	**$3.00**	**$3.13**	**$3.07**	**$2.96**	**$12.15**
GAAP EPS	$2.50	$2.65	$2.71	$1.97	9.83	$2.88	$1.35	$2.83	$3.15	$10.21	$3.00	$3.13	$3.07	$2.96	$12.15
Diluted Shares	235	235	232	229	233	228	228	224	224	226	215	215	214	213	214
Growth Analysis															
Revenue	+8%	+9%	+2%	+4%	+6%	+5%	+2%	+6%	+6%	+5%	(1%)	(1%)	(1%)	(1%)	(1%)
COGS (continuing operations)	+9%	+10%	+2%	+4%	+6%	+5%	+3%	+6%	+6%	+5%	(1%)	(1%)	(1%)	(1%)	(1%)
Gross profit (continuing operations)	(1%)	(3%)	(3%)	(1%)	(2%)	(1%)	(3%)	(2%)	(1%)	(2%)	(6%)	(5%)	(5%)	(9%)	(6%)
SG&A (continuing operations)	(5%)	(7%)	(9%)	(7%)	(7%)	(4%)	(4%)	(2%)	(3%)	(3%)	(0%)	+1%	+0%	+1%	+0%
Operating Income (continuing operations)	+8%	+9%	+13%	+12%	+11%	+6%	(0%)	(2%)	+1%	+1%	(19%)	(18%)	(17%)	(29%)	(21%)
Diluted EPS Continuing Operations	+9%	+11%	+25%	+14%	+15%	+22%	+12%	(3%)	+5%	+9%	(4%)	(1%)	+5%	(10%)	(2%)
MSUSA Adjusted EPS	+7%	+9%	+15%	+12%	+11%	+20%	+13%	(2%)	+4%	+9%	(2%)	+0%	+6%	(8%)	(1%)
MCK Adjusted EPS	+25%	+18%	+10%	(17%)	+9%	+11%	(11%)	(10%)	+31%	+5%	(14%)	+6%	+7%	(7%)	(2%)
Expense Analysis															
COGS	94.13%	94.17%	94.04%	93.83%	94.04%	94.44%	94.49%	94.48%	94.25%	94.41%	94.71%	94.71%	94.72%	94.73%	94.72%
SG&A	4.14%	3.98%	4.08%	4.09%	4.07%	3.81%	3.71%	3.77%	3.76%	3.76%	3.85%	3.79%	3.82%	3.84%	3.82%
Tax Rate	29.9%	30.3%	26.2%	29.5%	29.0%	23.7%	25.2%	30.5%	30.5%	27.5%	27.5%	27.5%	27.5%	27.5%	27.5%
Margin Analysis Continuing Operations															
Gross margin	5.87%	5.83%	5.96%	6.17%	5.74%	5.56%	5.51%	5.52%	5.75%	5.80%	5.29%	5.29%	5.28%	5.27%	5.82%
Operating margin	1.73%	1.85%	1.89%	2.08%	1.88%	1.75%	1.80%	1.75%	1.99%	1.82%	1.44%	1.50%	1.46%	1.43%	1.46%
Pretax margin	1.57%	1.70%	1.73%	1.92%	1.84%	1.64%	1.69%	1.62%	1.88%	1.83%	1.57%	1.64%	1.58%	1.57%	1.81%
Net margin	1.07%	1.16%	1.25%	1.33%	1.20%	1.21%	1.23%	1.11%	1.28%	1.21%	1.11%	1.16%	1.13%	1.12%	1.13%
EBITDA Analysis															
D&A	$229.0	$222.0	$220.0	$214.0	$885.0	$242.0	$217.0	$219.0	$220.0	$898.0	$224.0	$224.0	$226.0	$227.0	$901.0
EBITDA	$1,050.0	$1,125.0	$1,123.0	$1,183.0	$4,481.0	$1,112.0	$1,117.0	$1,105.0	$1,200.2	$4,534.2	$931.9	$965.0	$957.7	$926.4	$3,780.9
% year-over-year growth	+1%	+3%	+7%	+8%	+5%	+6%	(1%)	(2%)	+1%	+1%	(16%)	(14%)	(13%)	(23%)	(17%)
EBITDA Margin	2.21%	2.31%	2.34%	2.53%	2.35%	2.24%	2.24%	2.18%	2.43%	2.27%	1.90%	1.95%	1.91%	1.90%	1.92%
Adjusted Cash Operating Analysis															
Acquisition-related Amortization	*$112.0*	*$109.0*	*$108.0*	*$102.0*	*$431.0*	*$115.0*	*$115.0*	*$108.0*	*$98.0*	*$436.0*	*$115.0*	*$115.0*	*$108.0*	*$98.0*	*$436.0*
LIFO Adjustment	*$91.0*	*$91.0*	*$33.0*	*$29.0*	*$244.0*	*$47.0*	*($43.0)*	*$10.0*	*$20.0*	*$34.0*	*$20.00*	*$20.00*	*$20.00*	*$20.00*	*$80.0*
Adjusted EBITDA - Cash	$1,253.0	$1,325.0	$1,264.0	$1,314.0	$5,156.0	$1,274.0	$1,189.0	$1,223.0	$1,318.2	$5,004.2	$1,066.9	$1,100.0	$1,085.7	$1,044.4	$4,296.9
% year-over-year growth	(1%)	+1%	(0%)	+5%	+1%	+2%	(10%)	(3%)	+0%	(3%)	(16%)	(7%)	(11%)	(21%)	(14%)
Adjusted EBITDA Margin	2.64%	2.72%	2.64%	2.82%	2.70%	2.56%	2.38%	2.42%	2.67%	2.51%	2.17%	2.23%	2.17%	2.14%	2.18%
Adjusted Operating Income	$1,024.0	$1,103.0	$1,044.0	$1,100.0	$4,271.0	$1,032.0	$972.0	$1,004.0	$1,098.2	$4,106.2	$842.9	$876.0	$859.7	$817.4	$3,395.9
% year-over-year growth	+4%	+5%	+3%	+7%	+5%	+1%	(12%)	(4%)	(0%)	(4%)	(18%)	(10%)	(14%)	(26%)	(17%)
Operating Income Margin	2.15%	2.26%	2.18%	2.36%	2.24%	2.08%	1.95%	1.98%	2.23%	2.06%	1.71%	1.77%	1.72%	1.68%	1.72%

Source: Company reports and Mizuho Securities USA estimates. MCK Adjusted EPS excludes amortization of acquisition-related intangibles, acquisition expenses, litigation costs and LIFO adjustments. FY ends March 31st. MSUSA Adjusted EPS excludes amortization of acquisition-related intangibles, acquisition expenses, litigation costs, LIFO adjustments and one-time gains and other non-recurring one-time items.

Price Target Calculation and Key Risks

AAC Holdings, Inc.

Our price target of $9 is based on 8x our 2017E EV/Adjusted EBITDA. Although the shares deserve to trade at a premium valuation given the company's growth profile, valuation multiples appear unlikely to expand further given the ongoing legal issues in California. Risks to valuation include M&A integration, disruptions or delays to the development pipeline, the regulatory backdrop and increased competition. We intend to address the discrepancy between our rating and PT upon the conclusion of key upcoming legal proceedings.

Acadia Healthcare Company, Inc.

Our valuation of $45 is based on a sum-of-the-parts analysis for 2017E EBITDA. Risks to valuation include private and government payer reimbursement pressures, increased international and currency exposure, the intense regulatory landscape, multiple contraction, and competition fro acquisitions and integration risks.

Amerisource Bergen Corp.

Our valuation of $83 is based on a blended approach; averaging our implied price target from using 11.4x our MSUSA adjusted calendar 2017E EPS and our implied target from using a 7% yield on FY17 FCF estimates. Risks to valuation include pricing pressure from government and private payers, soft prescription drug utilization due the economy, loss of major clients and a competitive pricing environment

Cardinal Health, Inc.

Our valuation of $79 is based on a blended approach; averaging our implied price target from using 11.4x our MSUSA adjusted calendar 2017E EPS and our implied target from using a 7% yield on FY17 FCF estimates. Risks to valuation include pricing pressure from government, private payers and manufactures, soft prescription drug utilization, loss of major clients and a competitive pricing environment.

CVS Health

Our valuation of $90 assumes the company will trade at a mixed valuation of a free cash flow yield of 7% based on 2017E adjusted FCF and its 10-year low PE of 12.5x. Risks include continued soft prescription volume due to the economy, market share shifts resulting from the introduction of health reform, loss of key client contracts, increased government regulation, industry pricing pressure and increased competition.

Diplomat Pharmacy, Inc.

Our $17 price target is based on a 12.0x multiple applied to our 2017 adjusted EV/EBITDA estimate. Risks to our estimates include potential disruptions to the supply of key drugs, reimbursement pressures, contract losses, and concentrated ownership of shares outstanding. We intend to review our rating and price target pending upcoming results and guidance.

Envision Healthcare Holdings, Inc.

Our price target of $27 is based on 10.7x 2016E EV/EBITDA, is in-line with the group's 10-year trading multiple. Although our price target implies greater than 10% upside, we are maintaining our Neutral rating given the volatility to earnings coupled with the pending merger with AMSG. We will reevaluate our rating and price target when we publish our AMSG/EVHC merger model. Risks to valuation include pressure from government and private payers, industry regulation, wage inflation and a shortage

of qualified physicians, competition for acquisitions and a negative hospital volume and payer mix environment.

Express Scripts Inc.

Our valuation of $76 is based on a blended approach; averaging our implied price target from using 11.7x our MSUSA adjusted calendar 2017E EPS and our implied target from using a 7% yield on FY17 FCF estimates. Both methods are adjusted further for the potential reduction to EPS from the price check with a large client. Risk to valuation includes downside risk to EPS from its current contract negotiations with one of its largest clients, loss of key client contracts, continued soft prescription volume due to the economy, increased government regulation, and industry pricing pressure.

Laboratory Corp. of America Holdings

Our valuation of $135 is based on a blended approach; averaging our implied price target from using 14.7x our MSUSA adjusted 2017E EPS in-line with LH's 10-year average and our implied target from using a 6.5% yield on FY17 FCF estimates. Risk to valuation include integration issues with recent acquisitions, physician in-sourcing of lab testing, changes to pricing from government and private payors, introductions of Medicare co-payments and deductibles for laboratory services, continued weak testing volumes, competition and increased government regulation.

McKesson Corporation

Our valuation of $147 is based on a blended approach; averaging our implied price target from using 11.4x our MSUSA adjusted calendar 2017E EPS and our implied target from using a 7% yield on FY17 FCF estimates, then adjusting for the potential earnings reduction risk for changes in brand price inflation. Risks to valuation include pricing pressure from government, private payers and manufactures, soft prescription drug utilization, loss of major clients, a competitive pricing environment and integration of acquisitions.

MEDNAX, Inc.

Our $64 price target is based on a 10.8x multiple applied to our 2017E adjusted EV/EBITDA. Our valuation multiple is in-line with the current forward-year multiple and near the high-end of the industry average range of 11x-14x over the last two to five years. We view a premium valuation multiple as warranted given the company's earnings visibility and consolidation opportunity. Risks to our thesis include increased competition in the sector, government reimbursement pressures, client and affiliated physician retention rates, and M&A integration risks.

Quest Diagnostics Inc.

Our valuation of $103 is based on a blended approach; averaging our implied price target from using 16.4x our MSUSA adjusted calendar 2017E EPS and our implied target from using a 5% yield on FY17 FCF estimates. We think shares will trade at its 10-year high given cash deployment trends. Risks to valuation include integration of recent acquisitions, physician in-sourcing of lab testing, changes to pricing from government and private payors, introductions of Medicare co-payments and deductibles for laboratory services, continued weak testing volumes, competition and increased government regulation.

Quintiles IMS Holdings, Inc.

Our $90 price target is based on 20.5x our 2017E adjusted EPS of $4.40. Risks to our estimate include consolidation of clients, competition, pricing pressure, emerging market geopolitical risk and acquisition integration.

Rite Aid Corporation

Our valuation of $9 is based is on the pending deal price of WBA acquiring RAD. Risks to valuation include if the deal does not go through pending FTC approval.

Team Health Holdings Inc

Our price target of $38 is based on 11x 2017E EV/EBITDA, is in-line with TMH's two-year. We believe risk-reward appear balanced particularly given IPCM execution risks. Risks to our thesis include increased competition in the sector, acquisition integration risk, government reimbursement pressures, client and affiliated physician retention rates, increases in physician compensation, a change in payer mix, and M&A integration risks.

Universal Health Services Inc.

Our valuation of $115 is based on a sum-of-the-parts analysis for 2017E EBITDA. We believe UHS should be valued on a sum-of-the-parts analysis given the inherent growth potential driven by health reform in both businesses in the coming years. Risks to valuation include pricing pressure from government and private payers, continued soft volume growth, Las Vegas Exposure and further deterioration of bad debt.

Walgreens Boots Alliance, Inc.

Our valuation of $94 is based on WBA stand-alone using a mix of PE (16x our FY17E) and cash flow (6% FCF on FY17E). Risk to valuation include exclusion of pharmacy benefit manager (PBM) provider networks, sales pressures due to the economy, increased government regulation, changes to pricing benchmarks, European exposure with the Alliance Boots acquisition and the FTC approval of the pending acquisition of RAD.

Companies Mentioned (prices as of 1/02)

AAC Holdings, Inc. (AAC- Neutral $7.24)
Amerisource Bergen Corp. (ABC- Neutral $78.19)
Cardinal Health, Inc. (CAH- Neutral $71.97)
Diplomat Pharmacy, Inc. (DPLO- Neutral $12.60)
Express Scripts Inc. (ESRX- Neutral $68.79)
Laboratory Corp. of America Holdings (LH- Neutral $128.38)
MEDNAX, Inc. (MD- Neutral $66.66)
Quest Diagnostics Inc. (DGX- Buy $91.90)
Rite Aid Corporation (RAD- Buy $8.24)
UnitedHealth Group Incorporated (UNH- Buy $160.04)
Walgreens Boots Alliance, Inc. (WBA- Buy $82.76)
Acadia Healthcare Company, Inc. (ACHC- Buy $33.10)
AmSurg Corporation (AMSG- Neutral $67.75)
CVS Health (CVS- Buy $78.91)
Envision Healthcare Holdings, Inc. (EVHC- Neutral $63.29)
HCA Holdings, Inc. (HCA- Neutral $74.02)
McKesson Corporation (MCK- Neutral $140.45)
MidAmerican Energy Holdings Company (private- Not Rated)
Quintiles IMS Holdings, Inc. (Q- Buy $76.05)
Team Health Holdings Inc (TMH- Neutral $43.45)
Universal Health Services Inc. (UHS- Neutral $106.38)

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Rating Distribution

(As of 1/02)	% of coverage	IB service past 12 mo
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Hold (Neutral)	53.02%	34.90%

Sell (Underperform)	2.85%	50.00%

For disclosure purposes only (NYSE and FINRA ratings distribution requirements), our Buy, Neutral and Underperform ratings are displayed as Buy, Hold and Sell, respectively.

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