MORNINGSTAR

US Drug Distribution

Distributors play a crucial role in the drug supply chain and improve patient access to healthcare.

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Morningstar Equity Research

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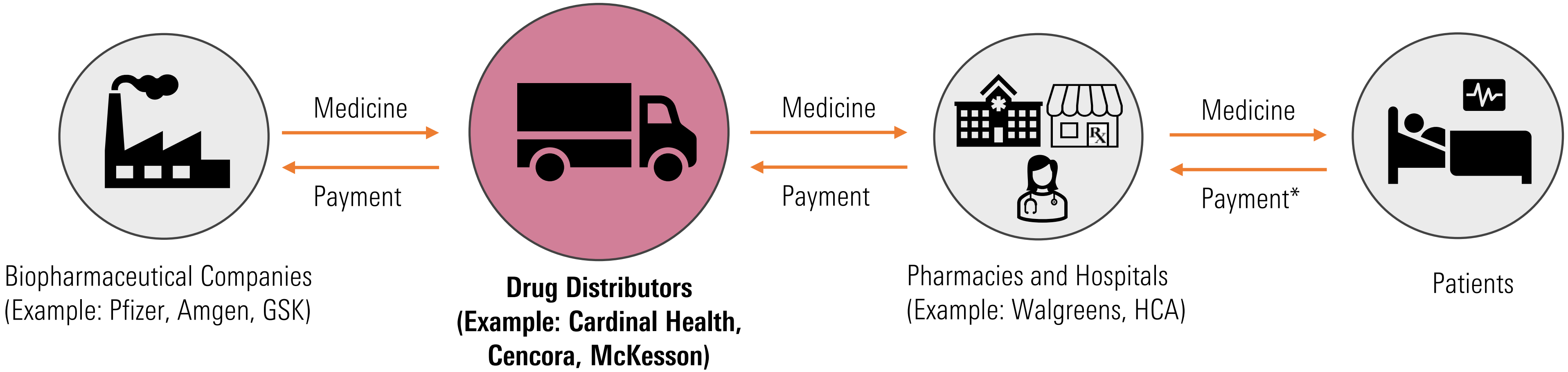
Executive Summary

Three main players dominate the US drug supply chain.

Industry Map

Drug distributors purchase pharmaceuticals from biopharma firms, store them, and safely deliver them to pharmacies, physician offices, clinics, and hospitals. Because distributors purchase and take ownership of pharmaceuticals, they allow manufacturers and healthcare providers to focus on their core competencies. Through scale-driven efficiencies, distributors can increase productivity in the drug supply chain and reduce capital and operating expenses, which can lower overall healthcare spending.

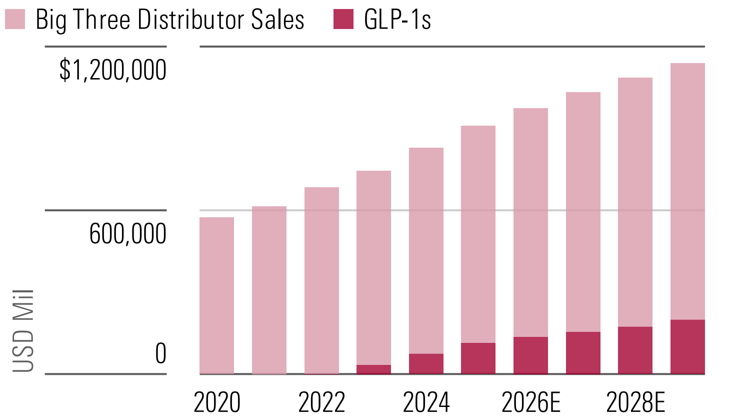
Pharmaceutical Supply Chain in US



Source: Morningstar.
*Inclusion of pharmacy benefit managers makes this illustration more complex.

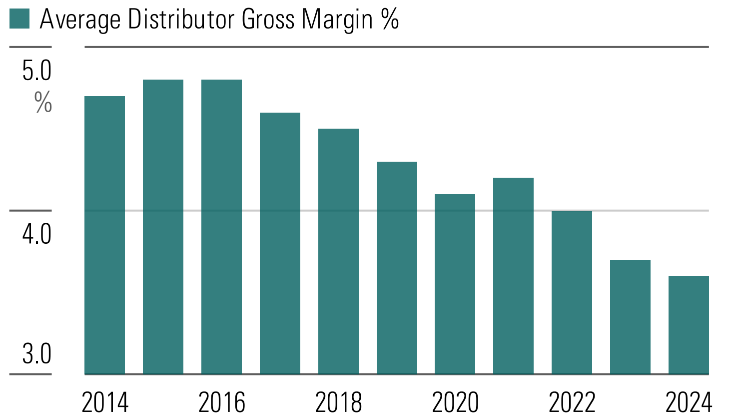
Key Industry Themes

GLP-1 Contributions Continue to Drive Growth



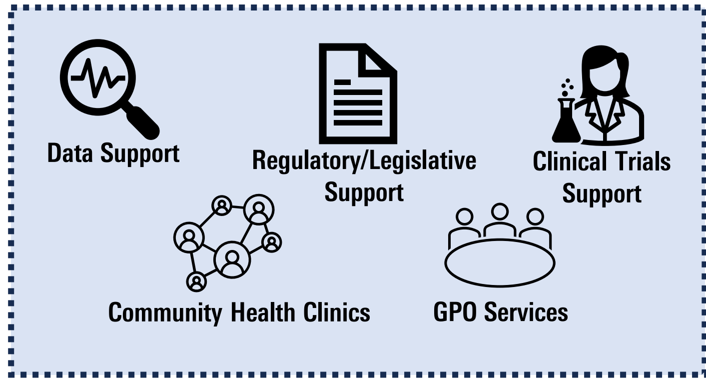
GLP-1s (diabetes and weight-loss drugs) provided significant tailwinds for all three distributors during 2024, and we expect this trend to continue. We estimate that about one fourth of the Big Three distributors' growth in the past 12 months was from GLP-1s. By our analysis, this class of medications made up a high-single-digit percentage of distributors' collective revenue in 2024, but we expect this level to jump to high teens by 2029.

Drug Pricing Dynamics Weigh Down Margins



While distributors' sales overwhelmingly come from branded drugs, their margins are heavily driven by generic drugs. Since 2015, the decline in generic drug prices has weighed down distributors' margins. The growth of branded and specialty therapies, which both have lower margins than generics, has also played a part in margin compression. While distributors benefited from high-margin covid vaccines in 2021, these contributions started to ease in 2022, and margin shrinkage continued.

Investments in Specialty Assets Bolster Offerings



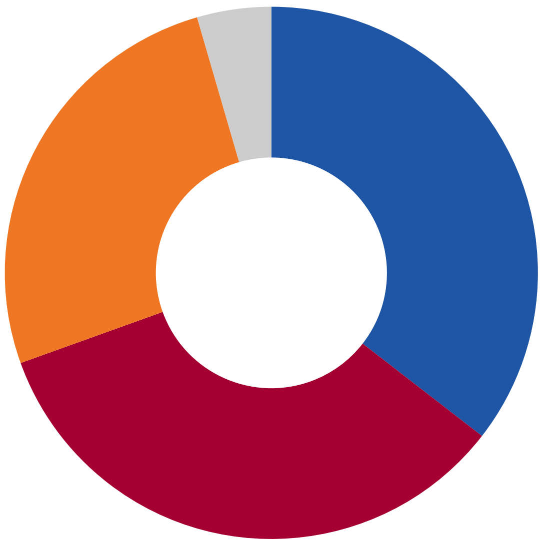
To combat margin headwinds from generic drug price erosion and growing expenditures on branded drugs, the Big Three distributors have invested in their specialty assets to offer higher-margin services to manufacturers, pharmacies, clinics, and hospitals. These investments are usually in oncology and other specialty therapeutic areas. The vertical integration of distribution and services positions the Big Three as not only distributors but also data, business strategy, and insights providers.

Source: Morningstar, company filings.

Market Share Concentration

Key Industry Players and Market Share by Revenue (2024)

Distributors	%
McKesson	35.50
Cencora	34.00
Cardinal Health	26.00
Others	4.50



Nearly all prescription drugs in the US are delivered through drug distributors. The three main players we cover—Cardinal Health, Cencora, and McKesson—make up more than 90% of the overall US drug distribution market, effectively acting as an oligopoly.

In April 2024, Cardinal announced that its contract with UnitedHealth's OptumRX would not be renewed, and McKesson revealed shortly after that it had won the contract. This new customer should contribute roughly $35 billion for 2025, so we expect McKesson's market position to outpace its two other competitors in the near term.

Outside of Cardinal, Cencora, and McKesson, the market is composed of independent drug distributors that specialize in specialty pharmaceuticals on the buy side and small and independent pharmacies and hospitals on the sell side.

Source: Morningstar, company filings.

Industry Value Drivers

Simplified Financial Statement: McKesson (Fiscal 2024)

Pro Forma Income Statement ($ Mn)	FY2024	% of Sales
Revenue 1	308,951	
Cost of Goods Sold 2	296,123	95.8%
Gross Profit	**12,828**	
Selling, Distribution, General and Adminstrative Costs 3	8,657	2.8%
Operating Income (excl. Charges)	**4,171**	**1.4%**
Restructuring Related Charges	115	
Claims and Litigation Charges	147	
Interest Expense	252	
Other Expense/(Income)	(132)	
Pretax Income	**3,789**	
Income Tax Expense	629	
Noncontrolling Interest	158	
Net Income	**3,002**	**1.0%**
Adjustments 4		
Adjusted Net Income		
Operating Income	**4,171**	
Amortization and Other	382	
Earnings Before Interest	**4,553**	
Depreciation	253	
(Capital Expenditures)	(687)	
Net Change in Investments and Other	778	
(Net Acquisition)/Divestments 5	(225)	
Net New Investment (NNI)	**119**	
Free Cash Flow to the Firm	**4,672**	

Key Income Statement Metrics *(Big Three Distributors' Fiscal 2024 Average in Italics)*

[1] Revenue: Drug distributors sell pharmaceuticals, over-the-counter medications, hospital supplies, and surgical instruments to pharmacies, hospitals, and clinics.

[2] Cost of Goods Sold (*96% of sales*): Upon getting paid by customers, drug distributors pay manufacturers, net of volume discounts, stocking allowances, and other rebates.

[3] SDG&A (*2% of sales*): Large distributors are extremely efficient and can drive down packing, handling, delivery, and personnel costs.

[4] Adjustments: Most firms exclude acquisition-related amortization, settlement charges, and restructuring and related charges.

[5] Acquisitions: Many distributors make acquisitions to bolster their offerings to pharmacies, manufacturers, and healthcare providers.

Source: Morningstar, company filings.

Coverage List and Ratings

Morningstar covers three companies in the US drug distribution industry across mid- and large market capitalizations.

US Drug Distributors Under Our Coverage

Company (Ticker)	Market Cap (USD Bil)	Moat Rating	Uncertainty Rating	Last Close (USD)	Fair Value Estimate (USD)	Star Rating	P/FVE	EV/Adjusted EBITDA	Dividend Yield	1-Year Return
Cardinal Health (CAH)	$31	Narrow	Medium	$132	$116	★★	1.14	10.2x	1.5%	24.6%
Cencora (COR)	$54	Narrow	Medium	$286	$242	★★	1.18	10.7x	0.8%	21.4%
McKesson (MCK)	$85	Narrow	Medium	$693	$550	★★	1.26	14.6x	0.4%	32.4%

Source: Morningstar, PitchBook. Data as of April 11, 2025.

Economic Moat

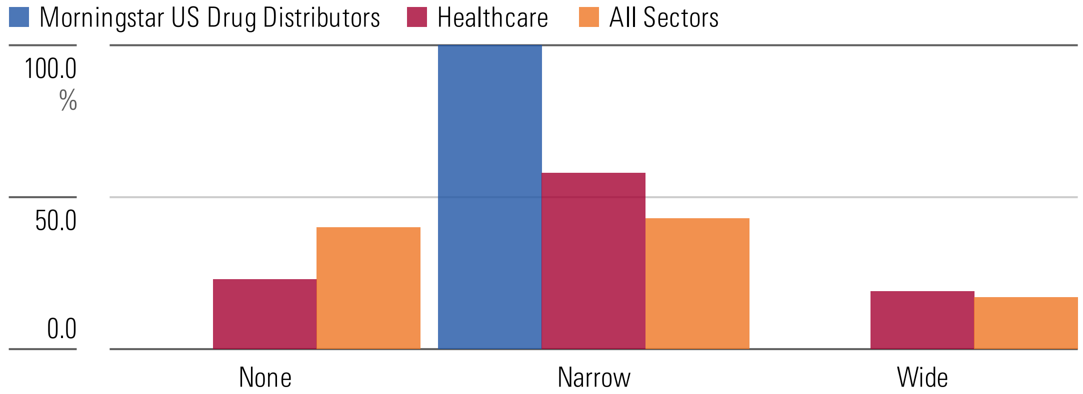
Switching costs uphold drug distributors’ narrow moats.

Summary of Moat Ratings and Sources

US Drug Distributors' Moat Distribution

All three US drug distributors in our coverage boast narrow economic moats. We think Cardinal Health, Cencora, and McKesson are all well-positioned to enjoy solid returns on invested capital above their weighted average cost of capital over the next 10 years and are highly unlikely to face any material competitive pressures from the market or regulatory actions that could inhibit their ability to generate excess returns. While other players in the drug supply chain, including manufacturers and pharmacy benefit managers, have been in the spotlight for regulatory overhauls, we think drug distributors are somewhat safeguarded from this.

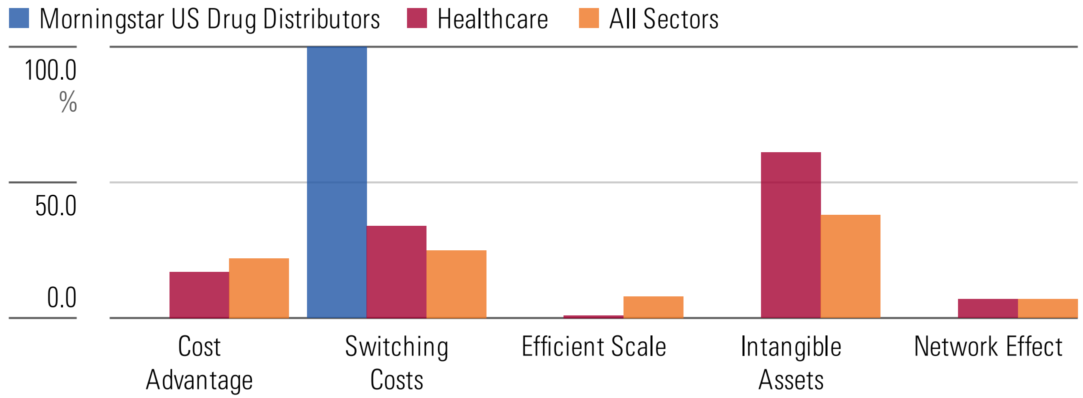
Distribution of Moat Ratings Compared With Cross-Sector Average



US Drug Distributors' Moat Source Distribution

While intangible assets are the main source among companies with moats in our coverage universe, customer switching costs are the sole moat source for Cardinal Health, Cencora, and McKesson. We think the deep relationships that the Big Three distributors have established over years of partnership with their customers are unlikely to materially deteriorate over the next decade. We think these relationships are augmented by generic sourcing joint ventures formed between the distributors and their partnering retailers—Red Oak Sourcing, Walgreens Boots Alliance Development, and ClarusONE, respectively—that help drive generic purchasing power for distributors.

Distribution of Moat Sources Compared With Cross-Sector Average



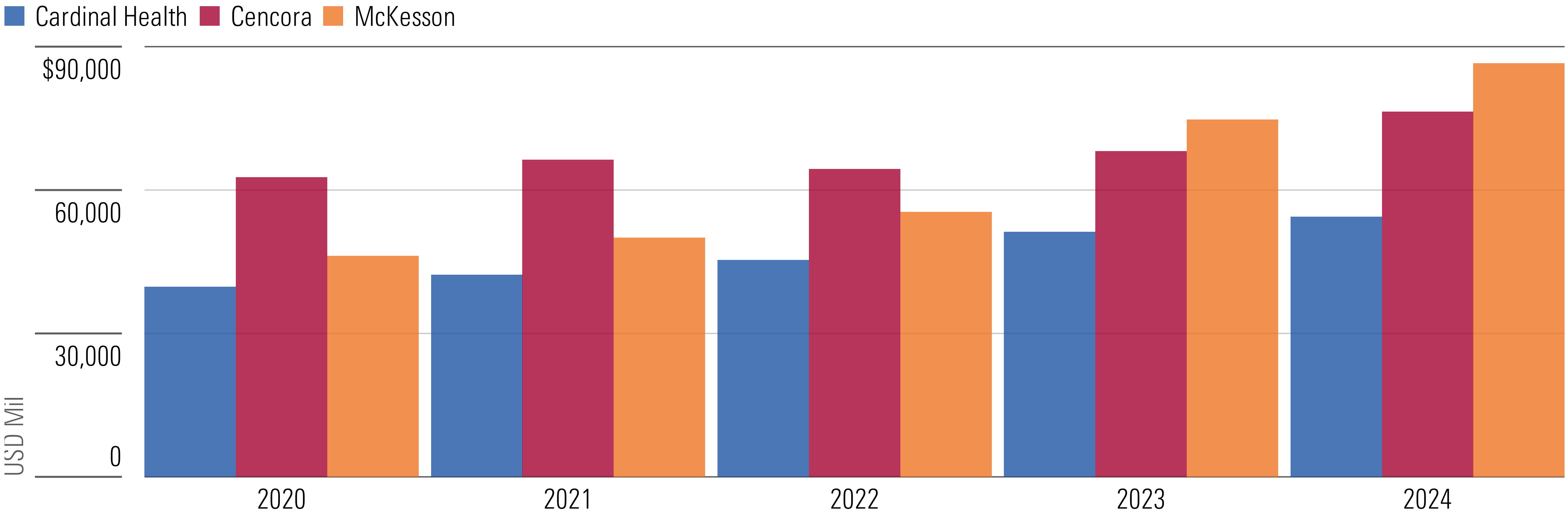
Source: Morningstar.

Increasing Revenue From Key Customers Make Distributors and Retailers Codependent

Key customers play an increasingly large role for their distributors as the portion of sales coming from them increases. On average, the top customer (CVS retail for Cardinal, CVS mail and specialty for McKesson, Walgreens for Cencora) makes up over one fourth of its distributor's total sales. We think an ever-increasing level of dependence between customers and their distributors deepens their relationships and substantiates switching costs.

Growing Sales From Distributors' Largest Customers Deepen Partnerships

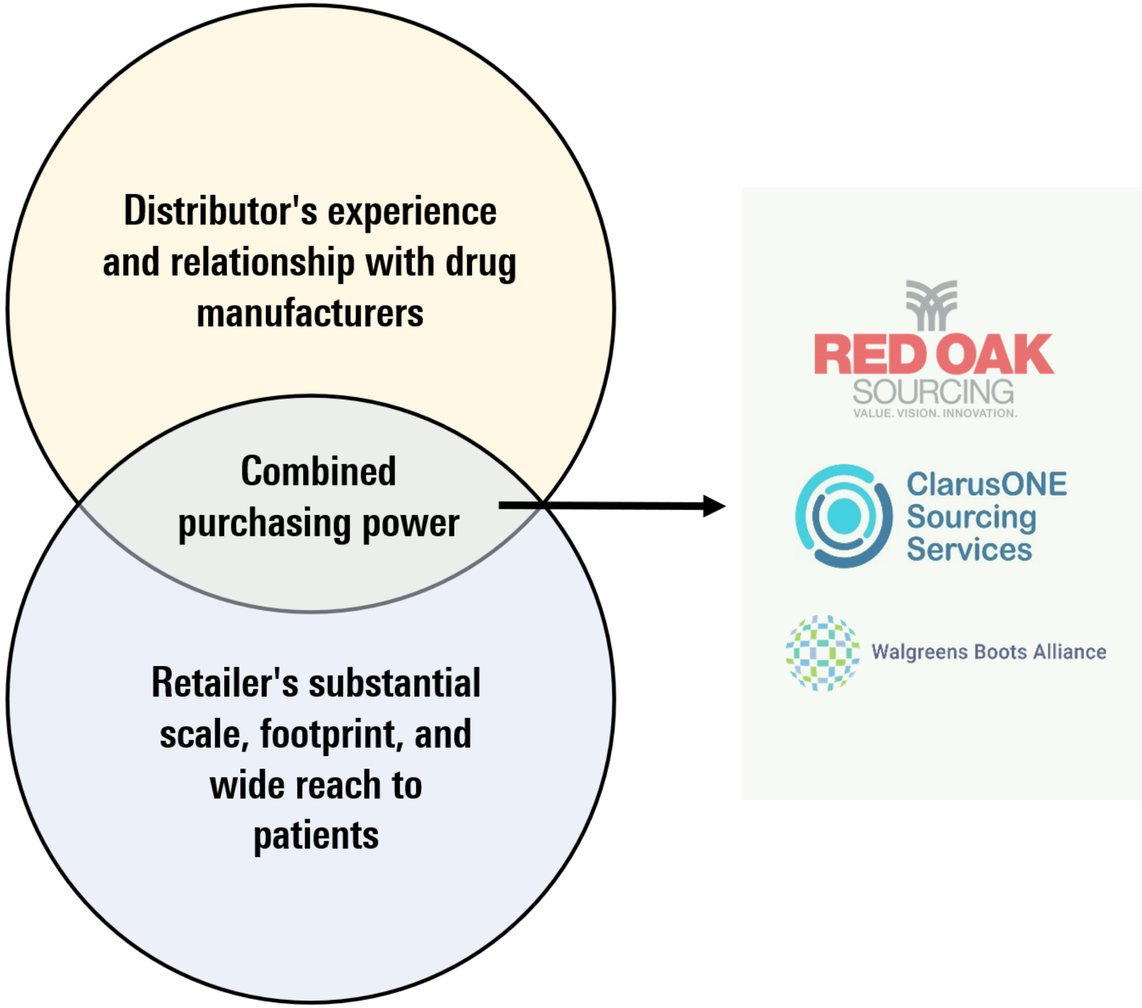
Cardinal Health (largest customer: CVS retail), Cencora (Walgreens), McKesson (CVS mail and specialty)



Source: Morningstar, company filings.

Generic Sourcing Joint Ventures Make Relationships Stickier

Joint Ventures Combine Purchasing Power of Two Large Entities and Secure Lower Prices for Generics



Source: Morningstar.

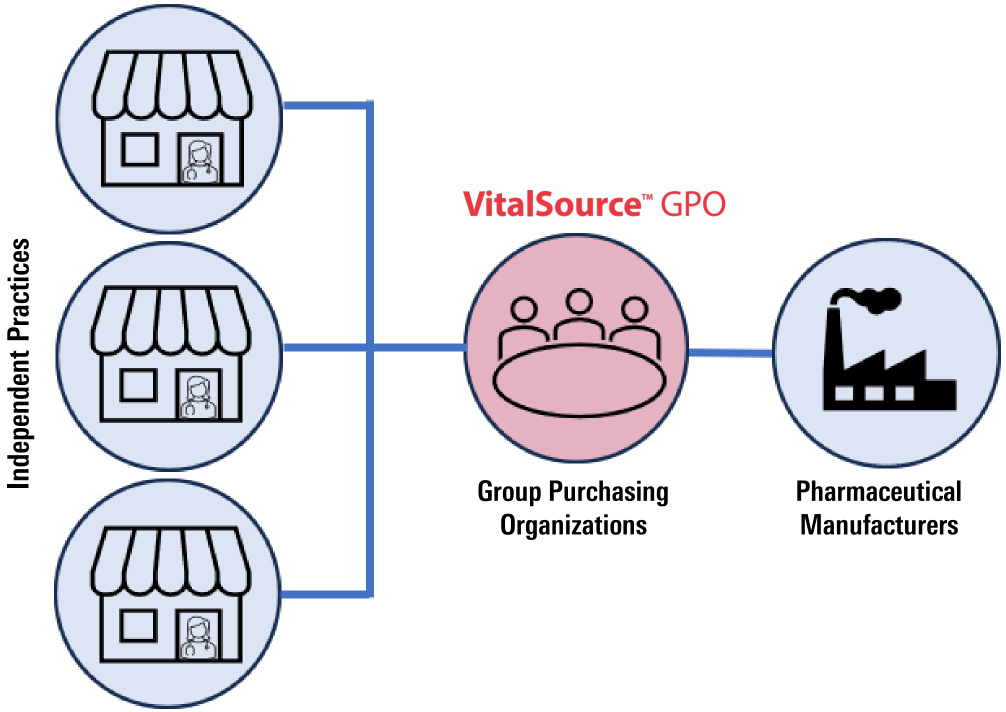
The Big Three distributors have formed generic drug sourcing joint ventures with major retailer partners to combine the buying volume of both parties. Cardinal Health and Cencora tapped their top customers—CVS and Walgreens, respectively—and McKesson partnered with Walmart. These joint ventures have significantly higher purchasing power than lone wholesalers or retailers, allowing them to secure lower prices for generic drugs. Furthermore, these long-standing joint ventures secure key customers for distributors for the foreseeable future and ensure appropriate inventory levels for retailers.

We think the formation of these purchasing consortiums deepens partnerships and amplifies switching costs between distributors and retailers. Given that generics make up roughly 90% of all prescribed drugs in the US, we think the financial incentive is too great for either party to unravel the joint venture. We also believe the intensive business integration and distribution chain set up between the distributor and retailer inhibits separation, since the operational disruption in finding a new partner can be extensive and costly.

Switching Costs Can Also Stem From Smaller Customers

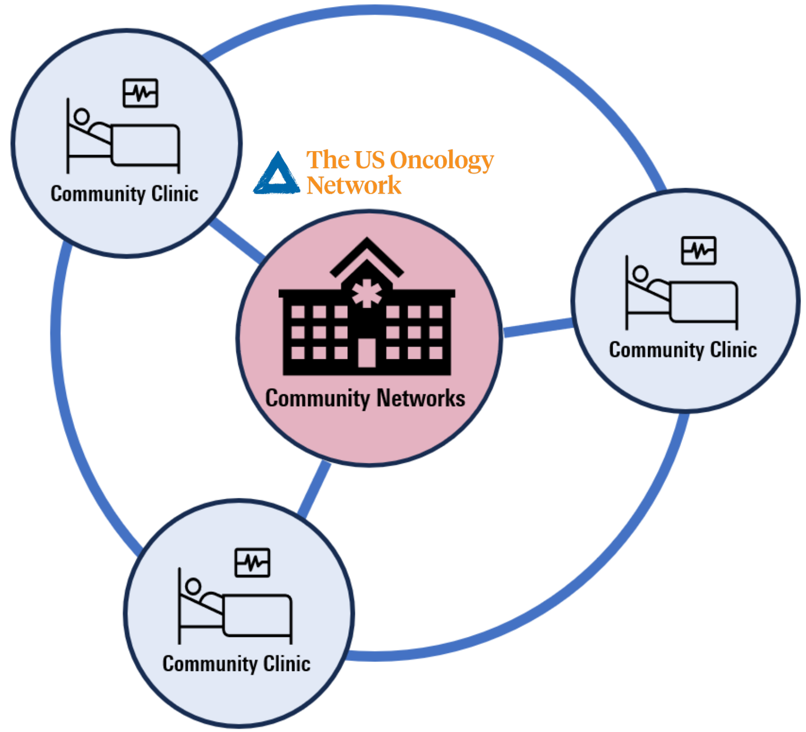
Group Purchasing Organizations Can Reduce Costs for Independent Practices

Example: Cardinal Health's VitalSource GPO



Community Networks Provide Valuable Support to Community Clinics

Example: McKesson's US Oncology



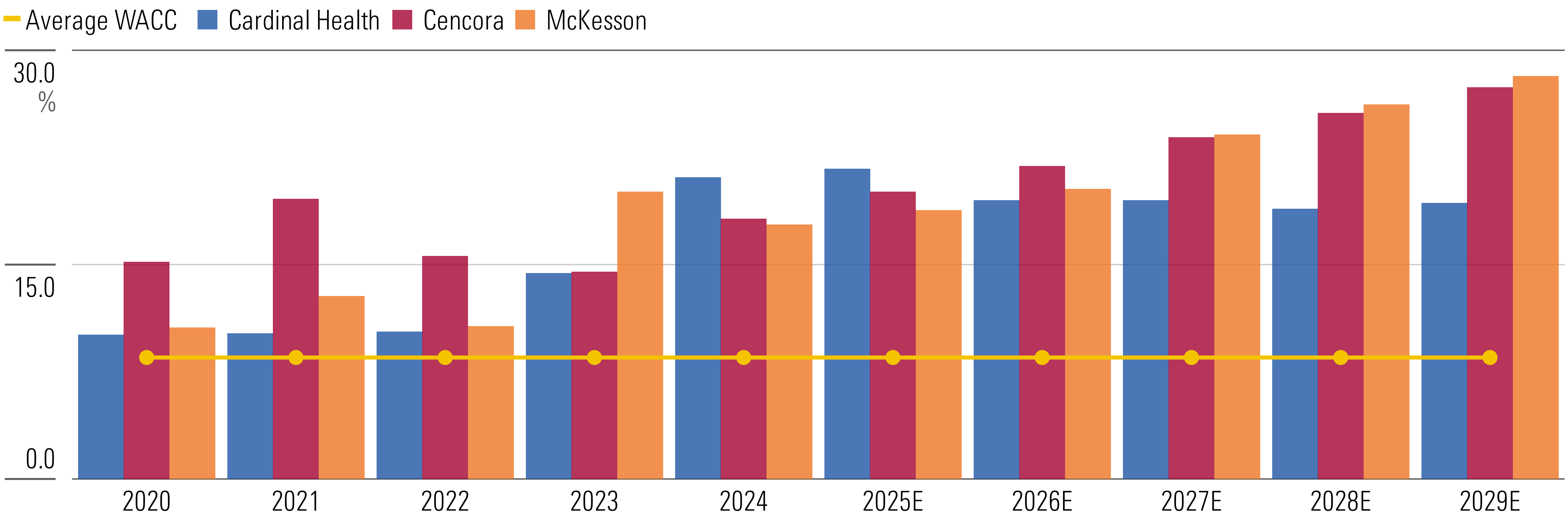
Drug distributors serve a wide base of customers. Although distributors don't have the same level of relationship with smaller and more community-based customers as they do with large retailers, they can still attain moderate switching costs through services like group purchasing organization support or community networks. By offering contract negotiation support, revenue-management services, and data and analytics insights, distributors can deepen relationships with their smaller customers.

Source: Morningstar.

Distributors Well Positioned to Outearn Cost of Capital Over the Next Decade

All three distributors have delivered returns on invested capital over their weighted average cost of capital over the past decade, and we expect this trend to continue for at least the next 10 years. While potential regulatory changes and market dynamic shifts in the overall drug supply chain keep us from awarding these three companies wide moat ratings, we think deep switching costs between distributors and their customers afford them narrow moats.

All Three Big Distributors Have ROICs Over WACC, and We Project Wider Spreads



Source: Morningstar.

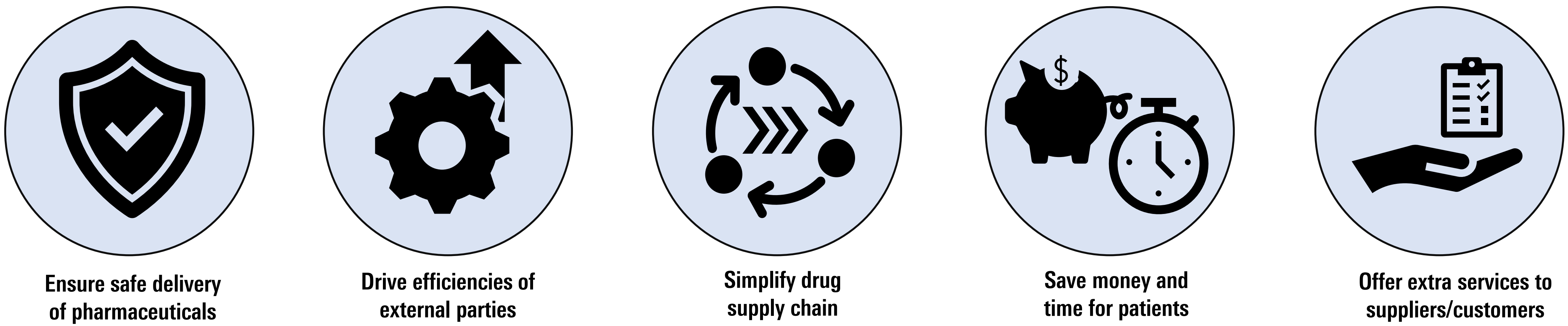
Industry Basics

Distributors play a key role in the drug supply chain by ensuring safe and timely delivery.

Drug Distributors Do More Than Move Pharmaceuticals From A to B

While the main responsibility of a drug distributor is delivering medicine from a manufacturer to a customer, there is more that distributors do for the overall drug supply chain. Distributors ensure the safety of drugs through proper storage and delivery methods, save money and time for manufacturers and customers, offer extra services to pharmacies and healthcare providers, and simplify and bring efficiency to the overall drug supply chain.

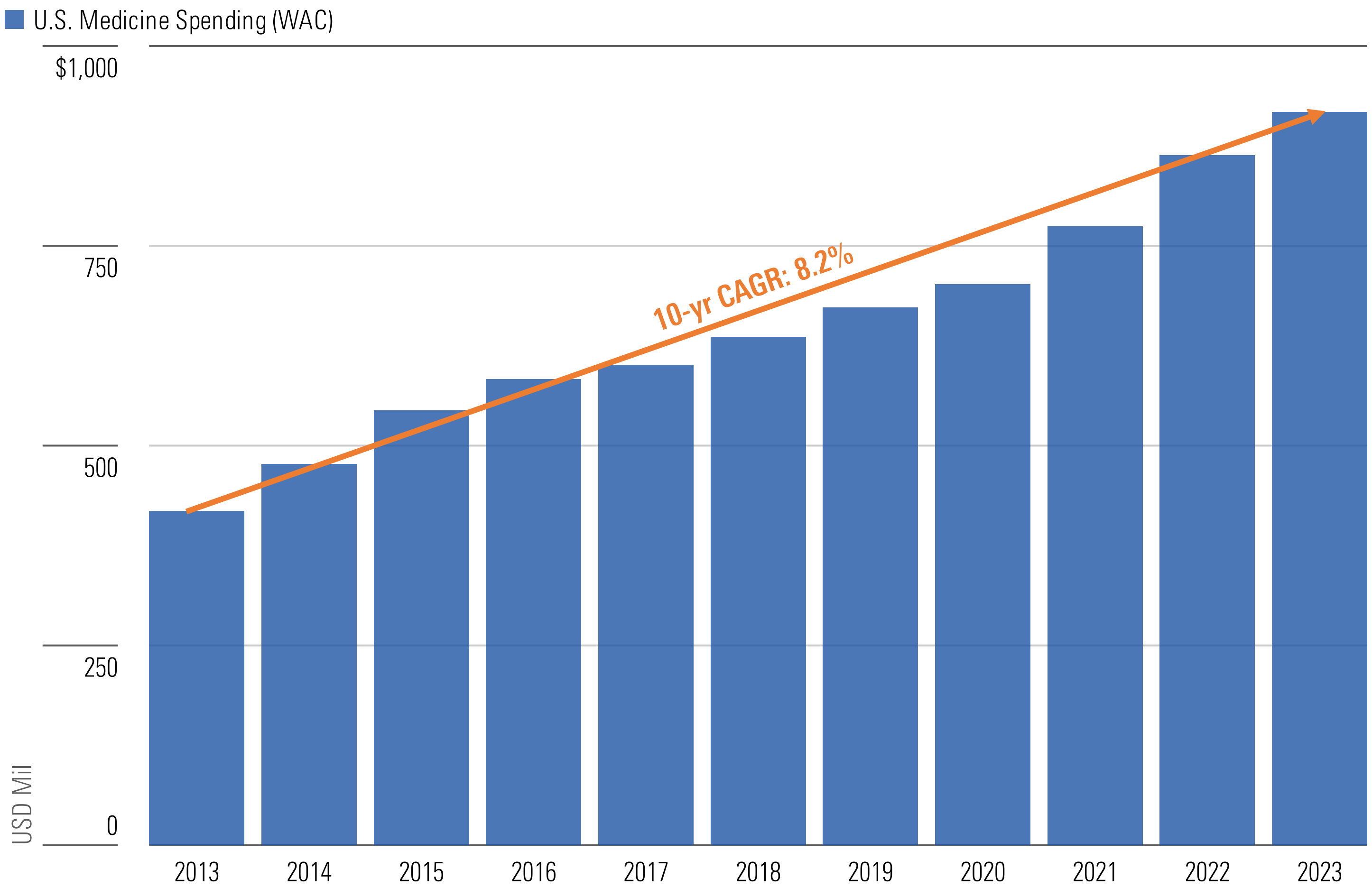
Role of Drug Distributors Spans Wide and Secures a Consistent Flow of Goods



Source: Morningstar.

Prescription Spending Grows Due to Aging Population and Increasing Access to Healthcare

US Medicine Spending Grows Annually at a High-Single-Digit Rate



Source: IQVIA. WAC = wholesale acquisition costs.

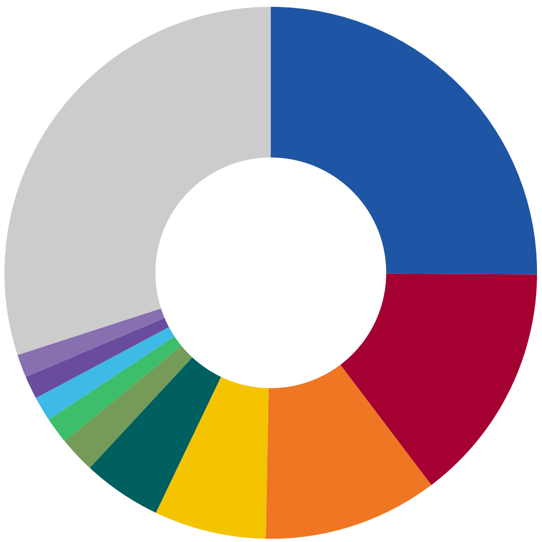
While the US represents less than 5% of the global population, it accounts for over a third of the global prescription drug market. US spending on medicines has grown consistently year over year as a result of increasing drug utilization rates, rising drug prices, and new treatment launches. We think an aging population and increasing access to healthcare play a pivotal role in increasing drug utilization.

Distributors directly benefit from growing medicine spending because their sales are largely driven by payments from pharmacies, hospitals, and clinics that administer medicines to patients. Consequently, the Big Three distributors have increased their sales at a rate similar to the growth of US medicine spending over the same time frame.

Distributors Have a Wide Base of Customers, and Their Relationships Are Crucial

The Big Three distributors serve a varied set of customers, including hospitals, clinics, and long-term-care facilities, but retail, mail, and specialty pharmacies are the largest type of customers they serve. Distributors have had longstanding partnerships with key customers—CVS' partnerships with McKesson and Cardinal Health span over 20 years, and Walgreens' partnership with Cencora spans over 10 years. This helps deepen their relationships and secures a big customer for the near term.

10 Largest US Pharmacies by Prescription Revenue Market Share (2024)



Company	%
CVS	25.10
Walgreens	14.60
Cigna	10.60
UnitedHealth	6.80
Walmart	4.80
Kroger	2.20
Humana	1.60
Rite Aid	1.50
Publix	1.40
Albertsons	1.40
Others	30.00

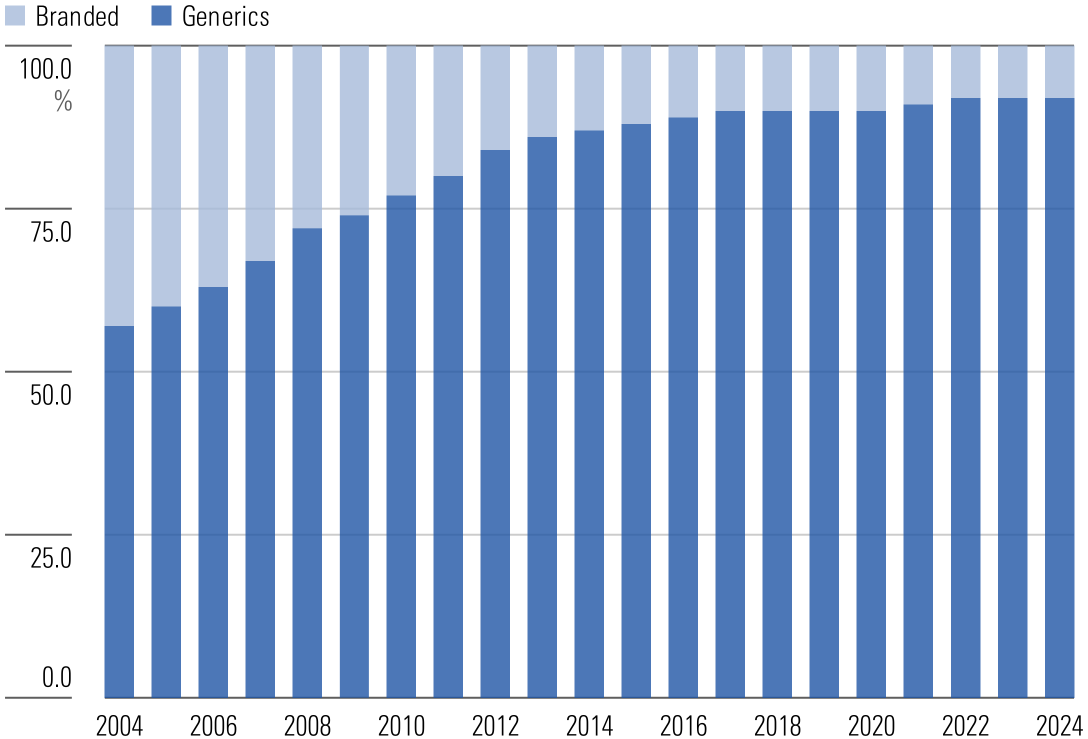
Select Key Customers and Their Distribution Partners

Company	Distributor	Agreement Expiry Date
CVS (Mail and Specialty)	McKesson	2027
CVS (Retail)	Cardinal Health	2027
Walgreens Boots Alliance	Cencora	2029
Evernorth (Cigna)	Cencora	2029
OptumRx (UnitedHealth)	McKesson	2029
Walmart	McKesson	Not Disclosed
Kroger	Cardinal Health	Not Disclosed
Rite Aid	McKesson	2029
Publix	Cardinal Health	2029
Albertsons	McKesson	Not Disclosed
Humana	Cencora	Not Disclosed

Source: Drug Channels Institute, Morningstar.

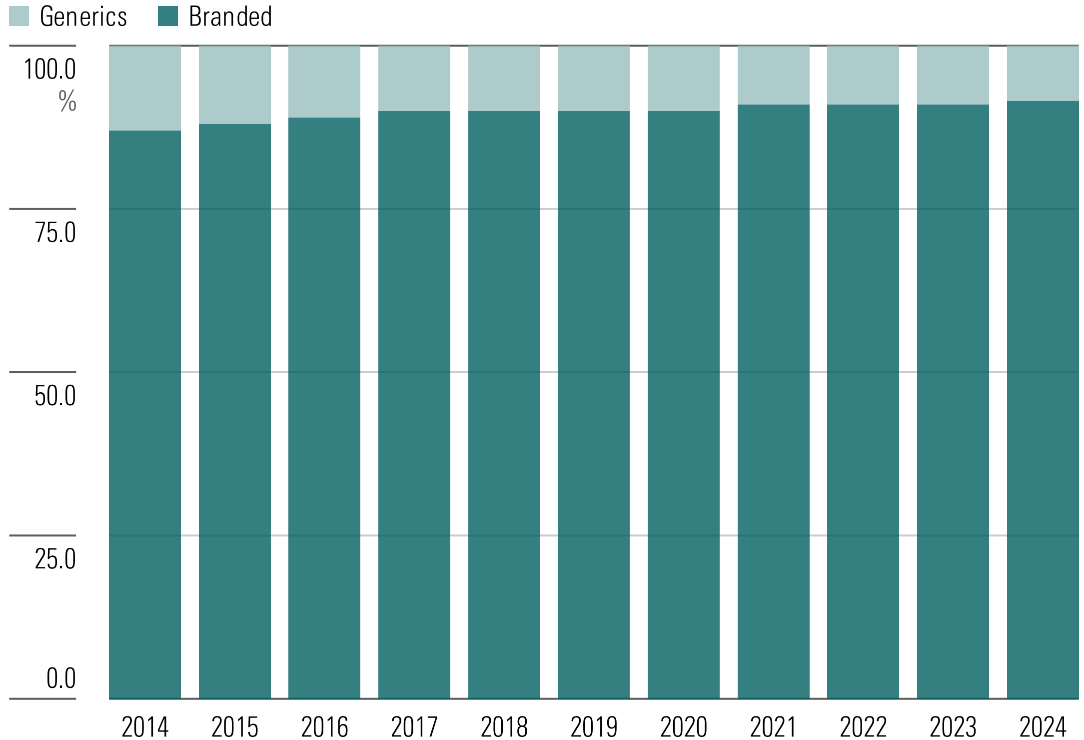
Generic Drugs Dominate US Prescriptions by Volume but Lag in Spending

Generic Drugs Make Up 9 Out of 10 Prescriptions Filled in the US…



While less than half of prescriptions filled in the US were for generic drugs at the beginning of the century, that number has jumped to over 90% in recent years thanks to efforts from the Food and Drug Administration and manufacturers.

…But Make Up Less Than 20% of Total Medicine Spending



Despite an increasing portion of prescriptions being filled by generics, the portion of total medicine spending in the US on branded drugs has increased. We think this is due to a combination of price erosion in generics and price inflation in branded drugs.

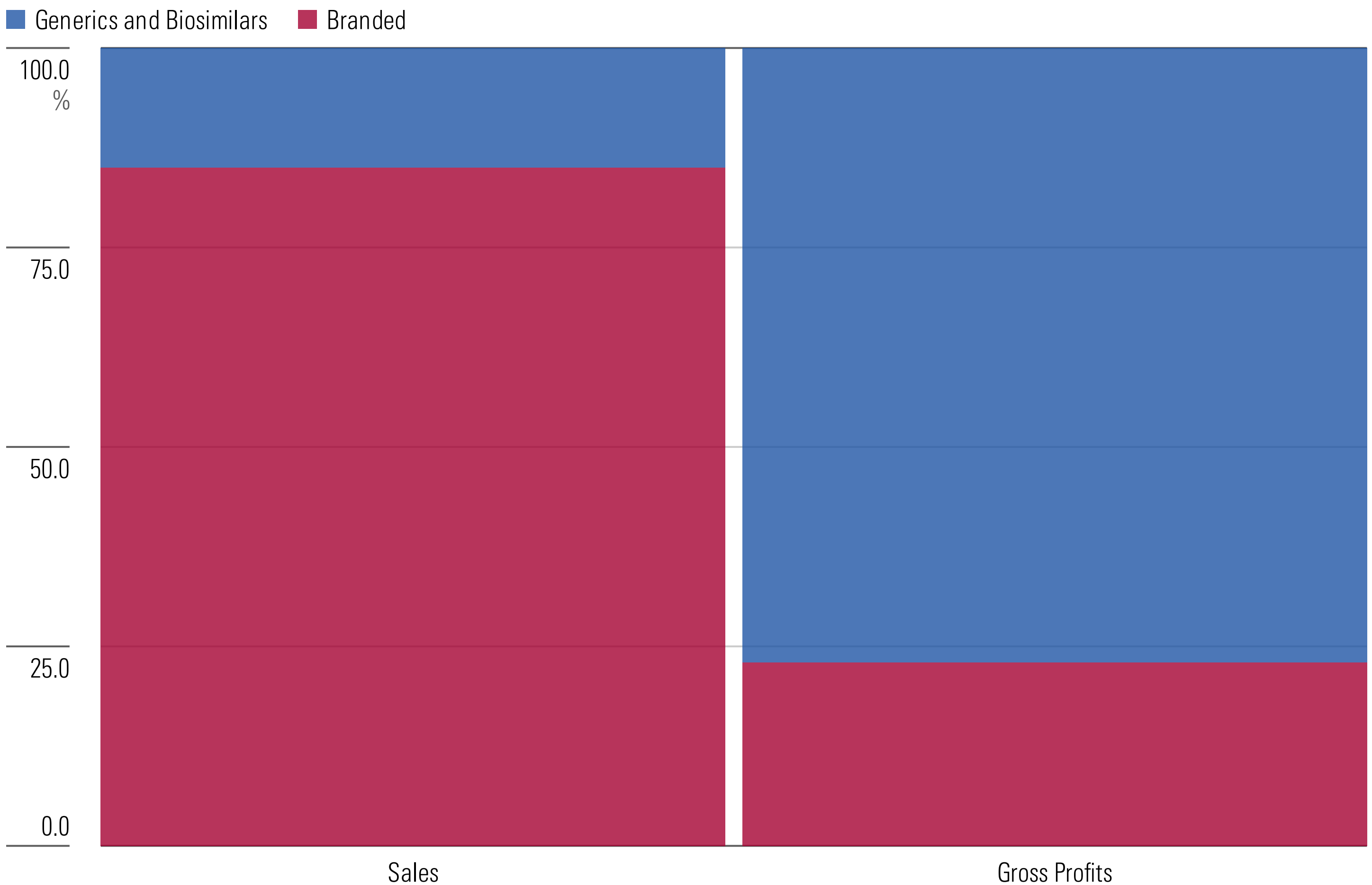
Source: Drug Channels Institute, Food and Drug Administration, KPMG, Morningstar.

Generic Drugs Play a Vital Role in Distributors' Margins

Despite making up over 90% of filled prescriptions, generic drugs and biosimilars (bioequivalent drugs of biologics) account for less than 20% of sales for distributors. This is due to their significantly lower costs compared with branded counterparts.

However, generics and biosimilars remain vital for distributors since they account for most of the firms' margins. Unlike the branded drug market, in which distributors have a single manufacturer for a specific branded drug and are price-takers, the generic drug market has several manufacturers all supplying essentially identical products, and they must compete to win distribution contracts, which allows distributors to be price-setters. Because of this, distributors can earn a significantly higher gross margin on generic drugs compared with branded drugs; S&P Global estimates that distributors make 11 times as much on generic drugs as they do on branded drugs. Since gross profits earned on generic drugs are somewhat tied to their list prices, declining prices—while they might not affect the top line due to inflating branded drug prices—have had a considerable impact on distributors' margins.

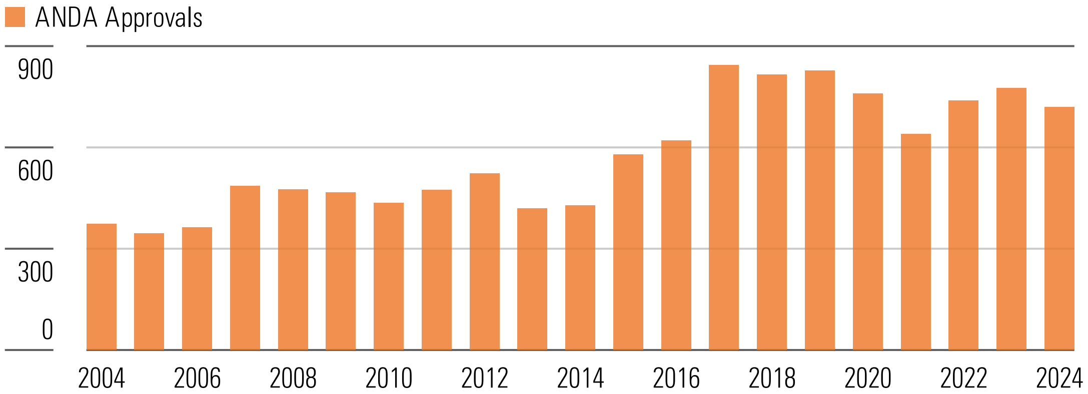
Branded Drugs Drive Sales, but Generics and Biosimilars Drive Gross Profits



Source: Morningstar, Drug Channels Institute, Healthcare Distribution Alliance.

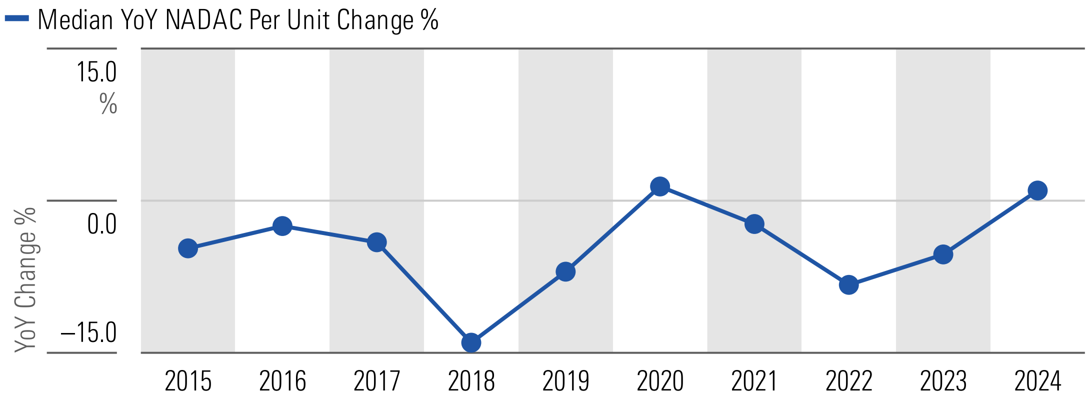
Increased Number of Approvals and High Utilization Rates Led to Declining Generics Prices

Number of Annual ANDA Approvals Doubled Since 2003



While generic drugs have been prevalent in the US since the early 20th century, they experienced significant growth when Congress enacted the Generic Drug User Fee Amendments (the first one passed in 2012, the second in 2017, and the latest in 2022). This allowed the Food and Drug Administration to collect fees from abbreviated new drug applications, via which US generic applicants can expedite the approval process. The fees (the ANDA fee rate for 2023 was around $240,000) are not meaningful enough to sway big generic manufacturers. They also provide additional revenue streams and financial support to the FDA, allowing applications to be approved more quickly and efficiently.

Price Erosion Is Common and Creates Headwinds



As generic drug utilization trended up and more ANDAs were approved, we saw more generic drugs enter the market. But since manufacturers fight for a fixed set of customers with essentially identical products, a simple function of supply and demand kicks in and results in falling prices for generic drugs. Additionally, the interchangeability between generics has facilitated the establishment of generic formularies, in which wholesalers can use their purchasing scale to negotiate deeper concessions for placement in the generic sourcing joint ventures that they formed with their partner retailers. According to our analysis of NADAC database, median generics prices fell 30% from 2015 to 2024. In recent years, price erosion for generics has stabilized to a low- to mid-single-digit annual decrease.

Source: Food and Drug Administration, Morningstar analysis of Medicaod.gov data.

Distributors Partner With Major Customers to Boost Purchasing Power

Big Three Distributors and Their Partners Purchased 80% of Generics in 2022

US Generic Drugs Purchasing Volume	%
Red Oak Sourcing	37.00
Walgreens Boots Alliance Dev.	22.00
ClarusONE	20.00
Others	21.00

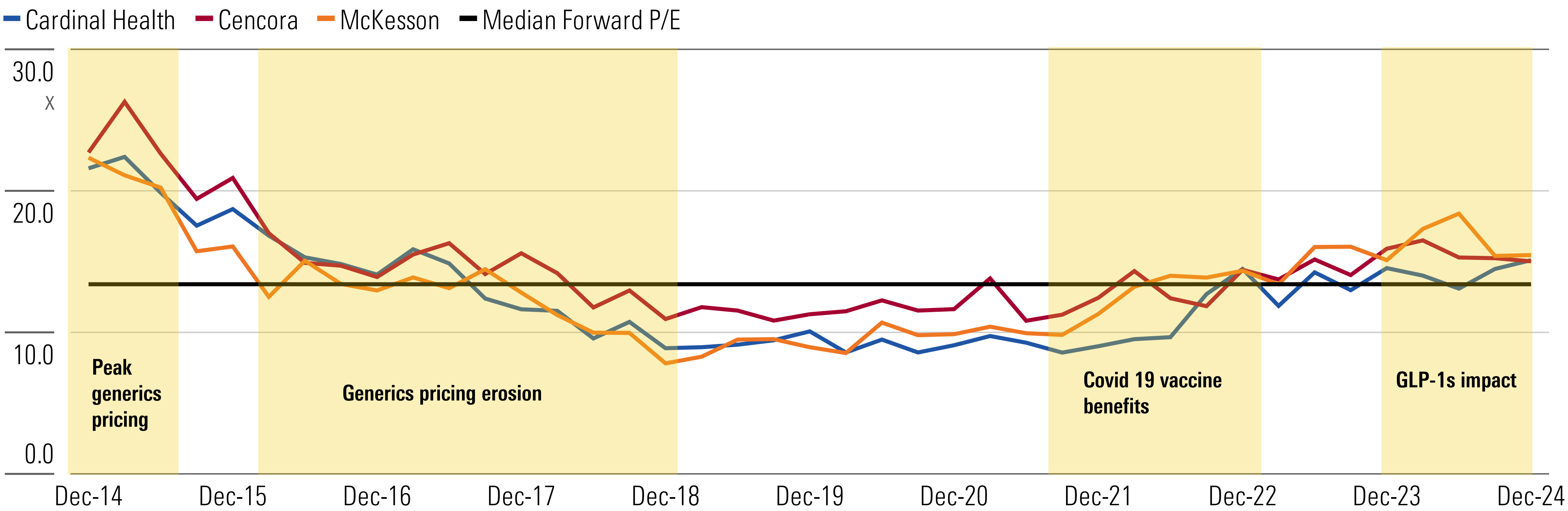
In an environment of decreasing generic drug prices and margin headwinds, the Big Three distributors have partnered with their major customers to boost their purchasing power. Red Oak Sourcing (Cardinal Health and CVS, formed in 2014), Walgreens Boots Alliance Development (Cencora and Walgreens, 2012), and ClarusONE (McKesson and Walmart, 2016) are generic sourcing joint ventures that combine the buying volume of major players in the industry. By doing so, they can negotiate higher discounts from generic drug manufacturers, which can help distributors capture higher profits. Distributors' partners are motivated to maintain their joint ventures because they can benefit from reduced costs if distributors share some savings with them. The three generic sourcing giants purchase roughly 80% of all generics sold in the US, but by value, they capture over 90%.

Source: Drug Channels Institute.

Falling Generic Prices Weighed Down Margins and Overall Distributor Valuations

While Morningstar uses discounted cash flows to determine fair value estimates, price/earnings metrics provide some historical valuation perspective. As distributors' margins got squeezed from falling generic prices and an increasing portion of sales going to their largest customers (which can negotiate larger discounts compared with smaller pharmacies), we saw their valuations drop accordingly. Valuations have rebounded in recent quarters, and the Big Three distributors now trade above their 10-year median P/E.

After Years of Trading Below 10-Year Median P/E, Distributors Now Trade at a Slight Premium



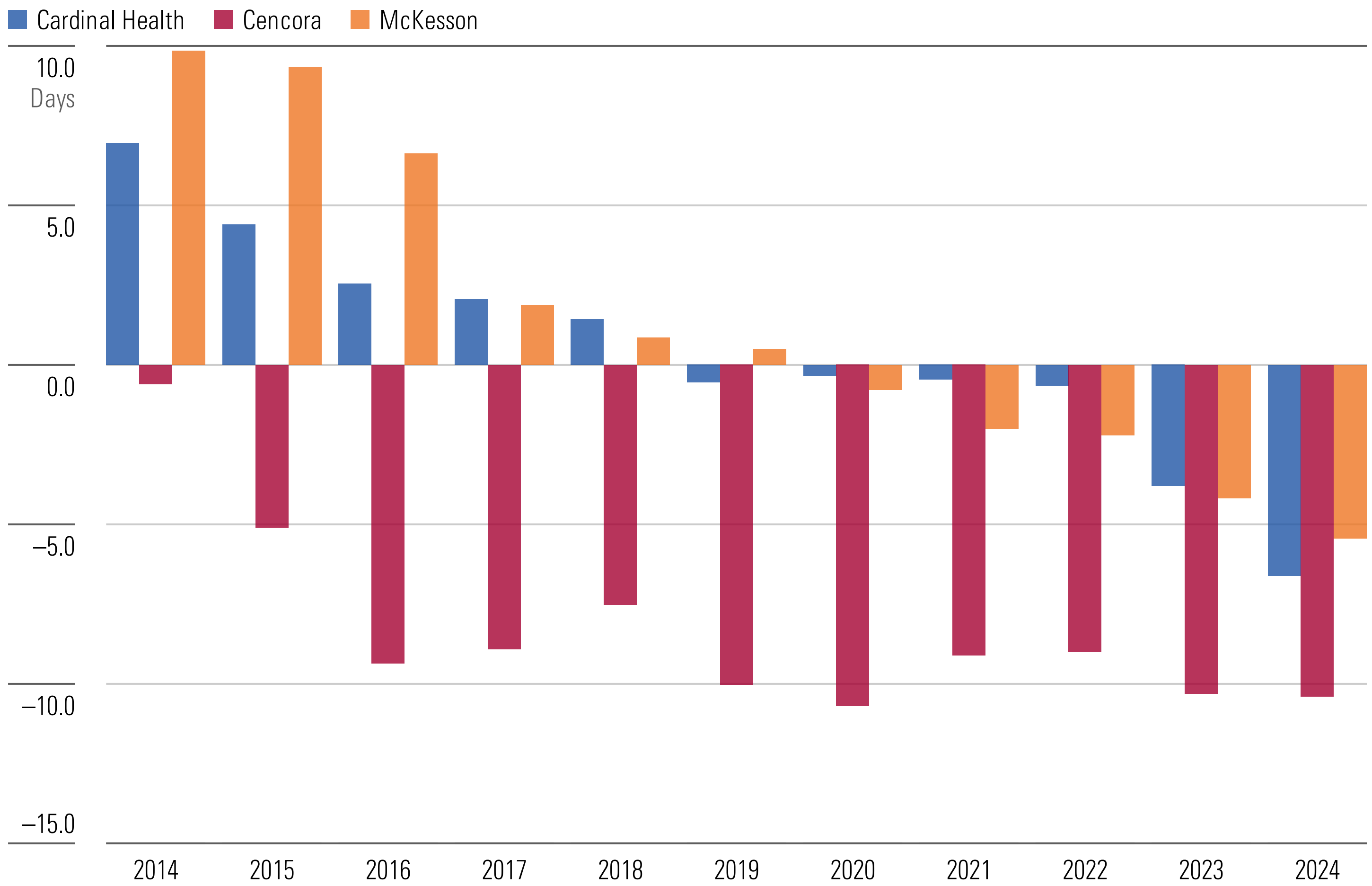
Source: Morningstar, PitchBook.

Cash Conversion Cycle Benefits From Increased Generic Dispensing Rates

The cash conversion cycle (receivable days plus inventory days minus payable days) measures how quickly firms convert inventory into cash. While this metric varies widely among industries, a low or negative cash conversion cycle usually indicates effective inventory and working capital management.

For drug distributors, a negative conversion cycle means they receive and sell drugs before they need to pay manufacturers. This can have a positive impact on their cash flows. Over the past decade, distributors have improved their conversion cycles mainly by lengthening payable days. We think increasing generic drug utilization benefits this because distributors have more negotiation leverage with generic manufacturers than branded manufacturers, which allows them to pay back more slowly.

All Three Distributors Have Improved Cash Conversion Cycles Over the Past Decade

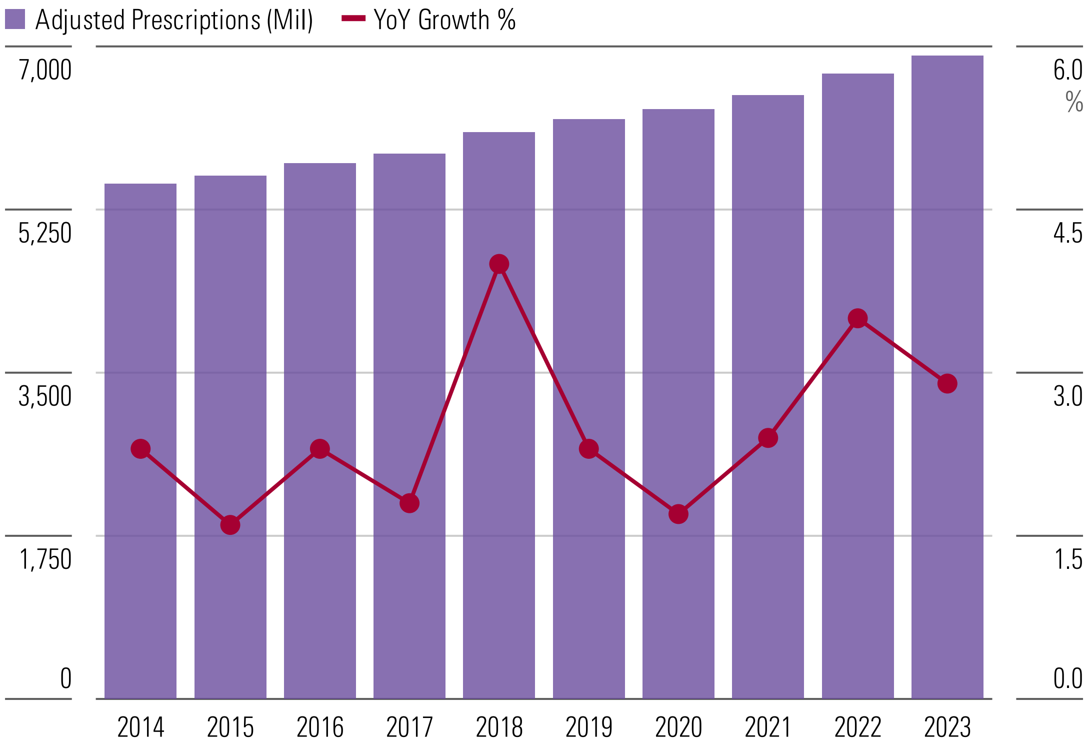


Source: PitchBook, company filings.

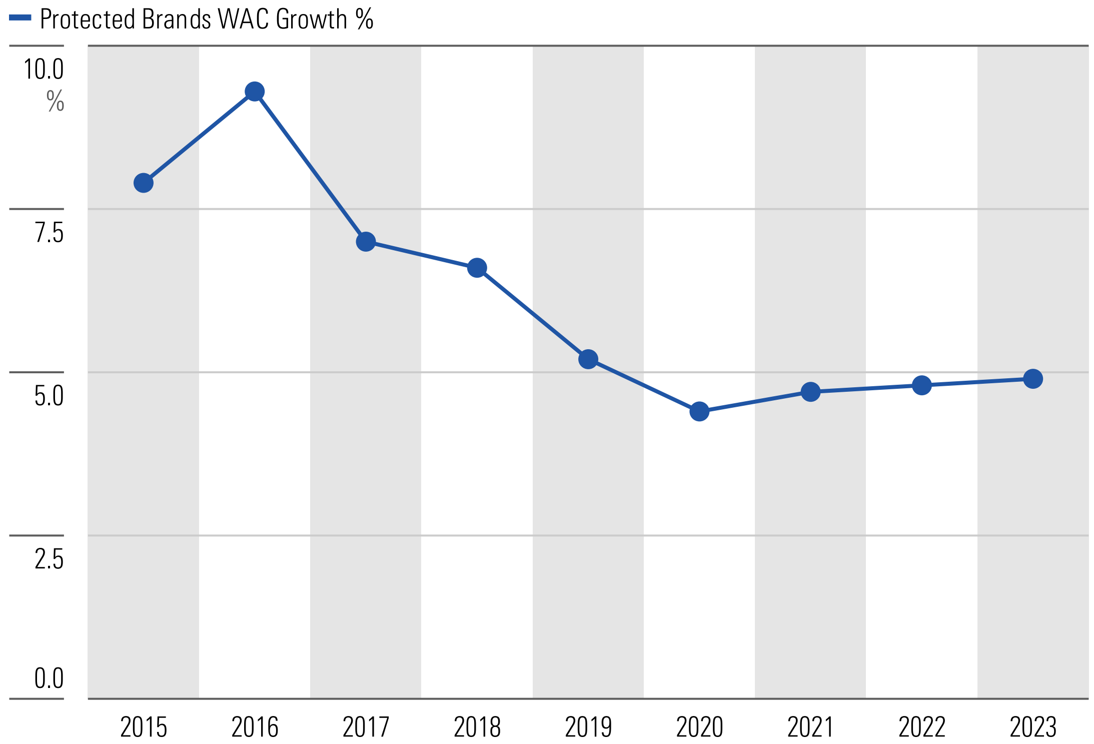
Prescription Volume and Branded Drug Prices Continue to Grow Year Over Year

We see a similar trend for the branded side of the equation as for the generic side. Drug distributors' top lines enjoy tailwinds when list prices for drugs rise; this has been the case year over year for the past decade. While the slowdown in list price hikes in recent years could temper growth for distributors, we think this will be offset by the growth in prescription volume driven by an aging population, new available treatment options, and increasing access to healthcare.

Prescription Volume Consistently Grows by Low-Single Digits



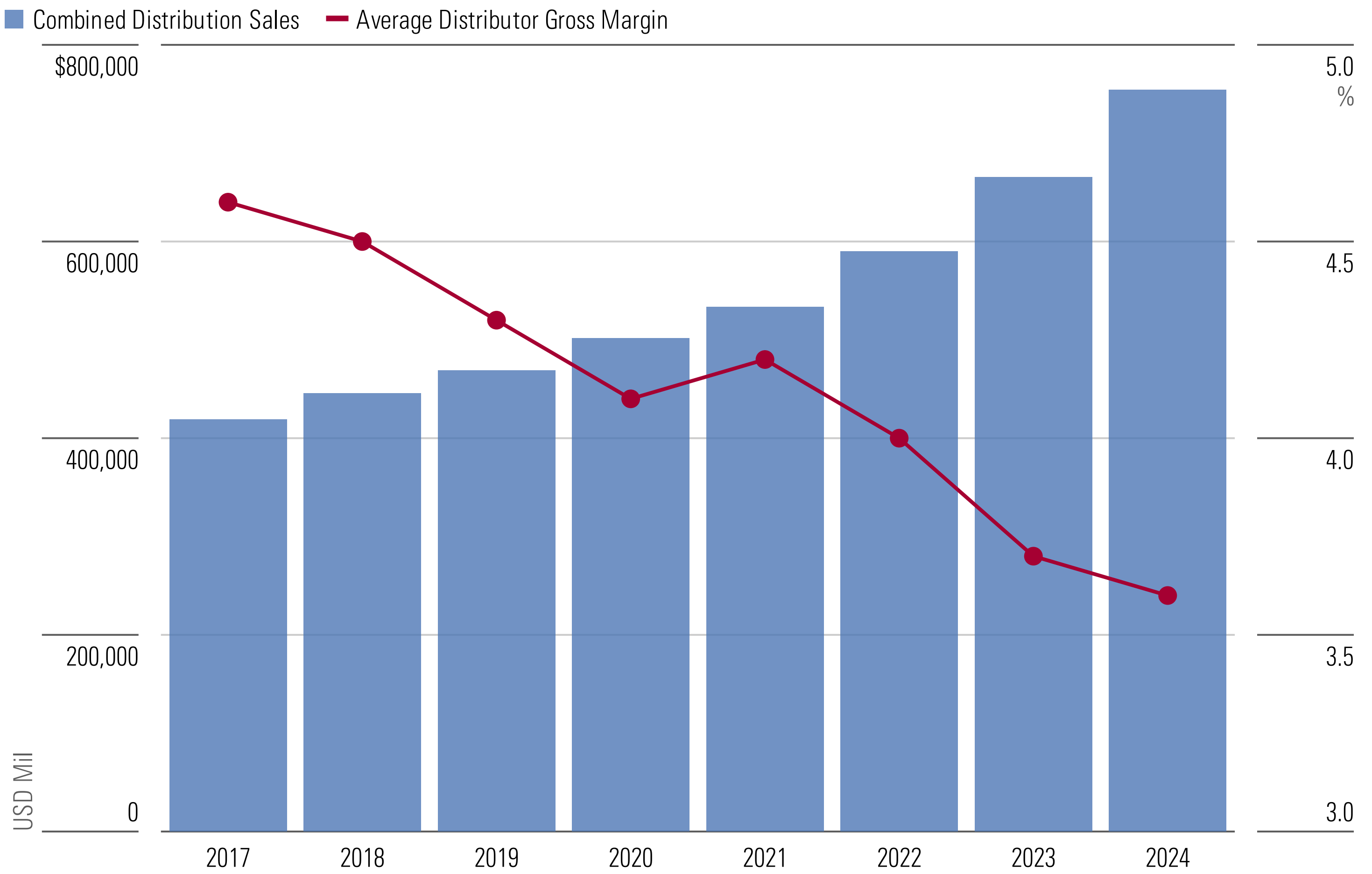
Wholesale Acquisition Cost Growth Has Slowed Recently but Is Still Rising



Source: IQVIA. Prescriptions are adjusted for length.

Rising Branded Drug Prices Boost Sales but Hurt Margins

Favorable Drug Pricing Dynamics Fuel Sales but Have an Inverse Impact on Margins



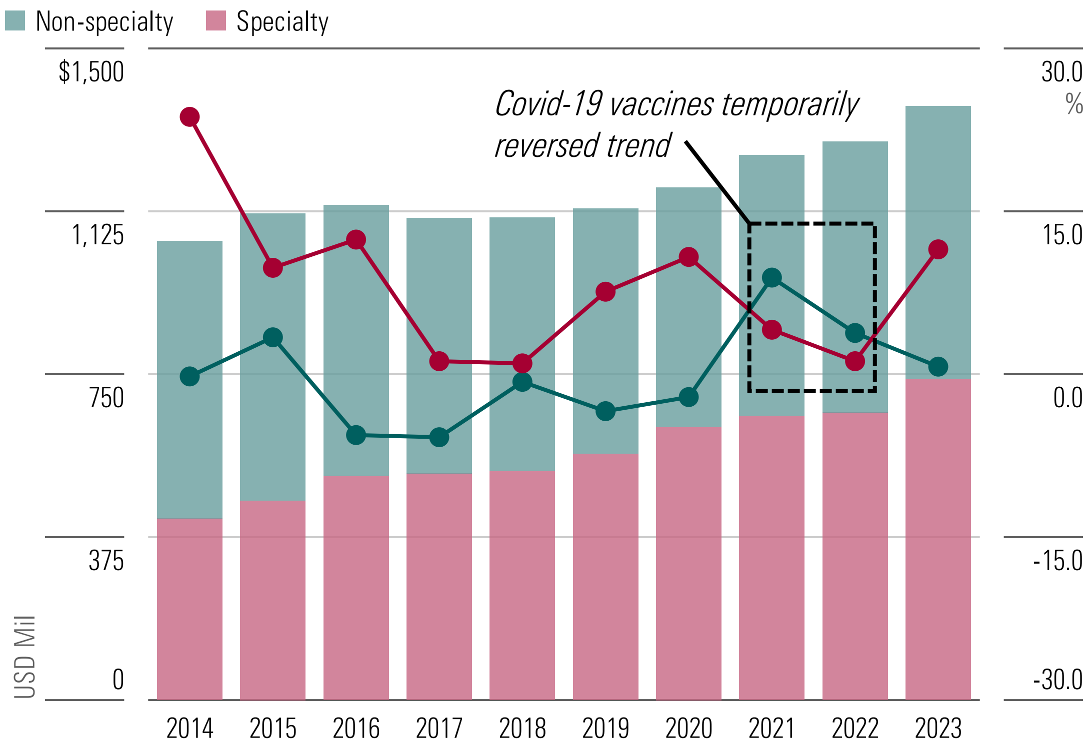
Source: Morningstar, company filings.

Unlike their generic counterparts, branded drugs have seen their list prices increase year over year as manufacturers work to offset rebate pressures from pharmacy benefit managers. Since branded drug prices are directly tied to distributors' top lines, this price inflation has helped drive sales growth.

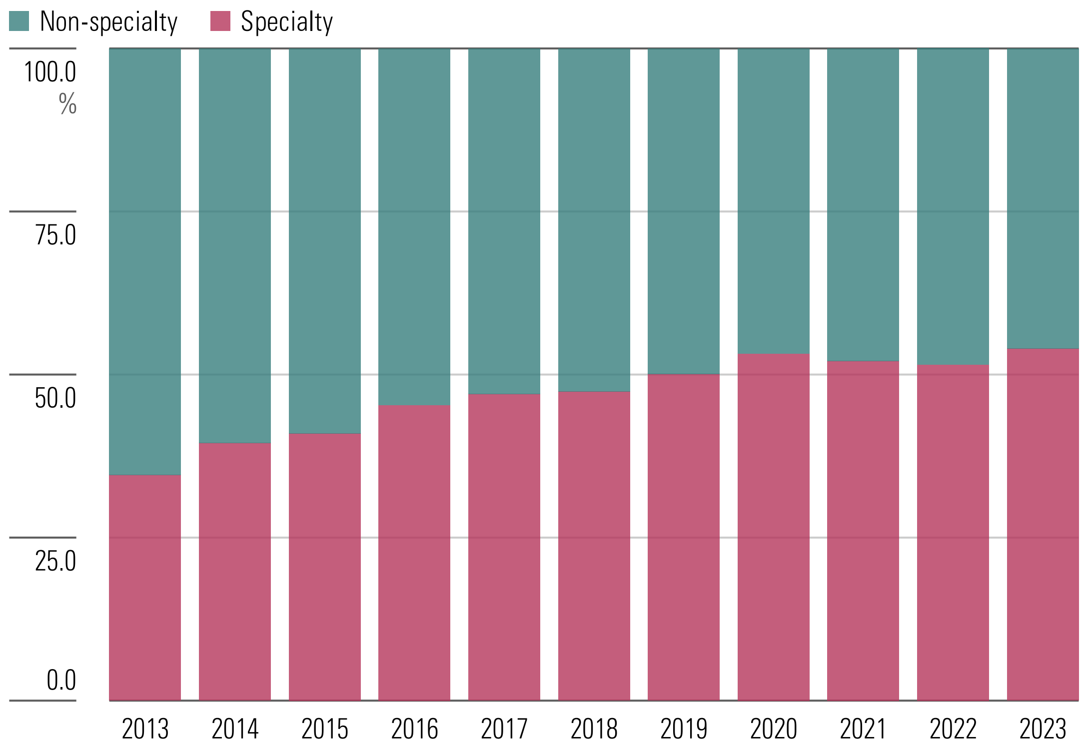
This has had an inverse impact on margins. Profit per prescription for branded drugs that distributors receive used to be closely tied to prices, so an increasing branded drug price somewhat protected distributors' margins. But now all three distributors see very minimal gross profit impact from rising prices because most branded drug buy-side dollars are fee-for-service. This means that despite an increase in drug prices, the fees that distributors receive largely remain the same. This dynamic compresses distributors' margins. We have seen this at play over the past several years with no signs of the trend reversing. If branded drug prices keep rising and generic drug prices keep falling, distributors will continue to face margin headwinds.

Specialty Drugs Make Up More Than Half of US Prescription Drug Expenditures

Specialty Drugs Grow Faster Than Overall Market …



… And Continue to Gain Market Share in Total Prescription Spending



Specialty drugs (drugs for rare or complex health conditions) make up a low-single-digit percentage of overall US prescription volume but represent over half of total drug spending. This is caused by significantly higher price tags that specialty drugs carry compared with branded and generic drugs. Specialty drugs are also growing much faster than their generic and branded counterparts and have made up most of the total pharmaceutical expenditure growth in recent years.

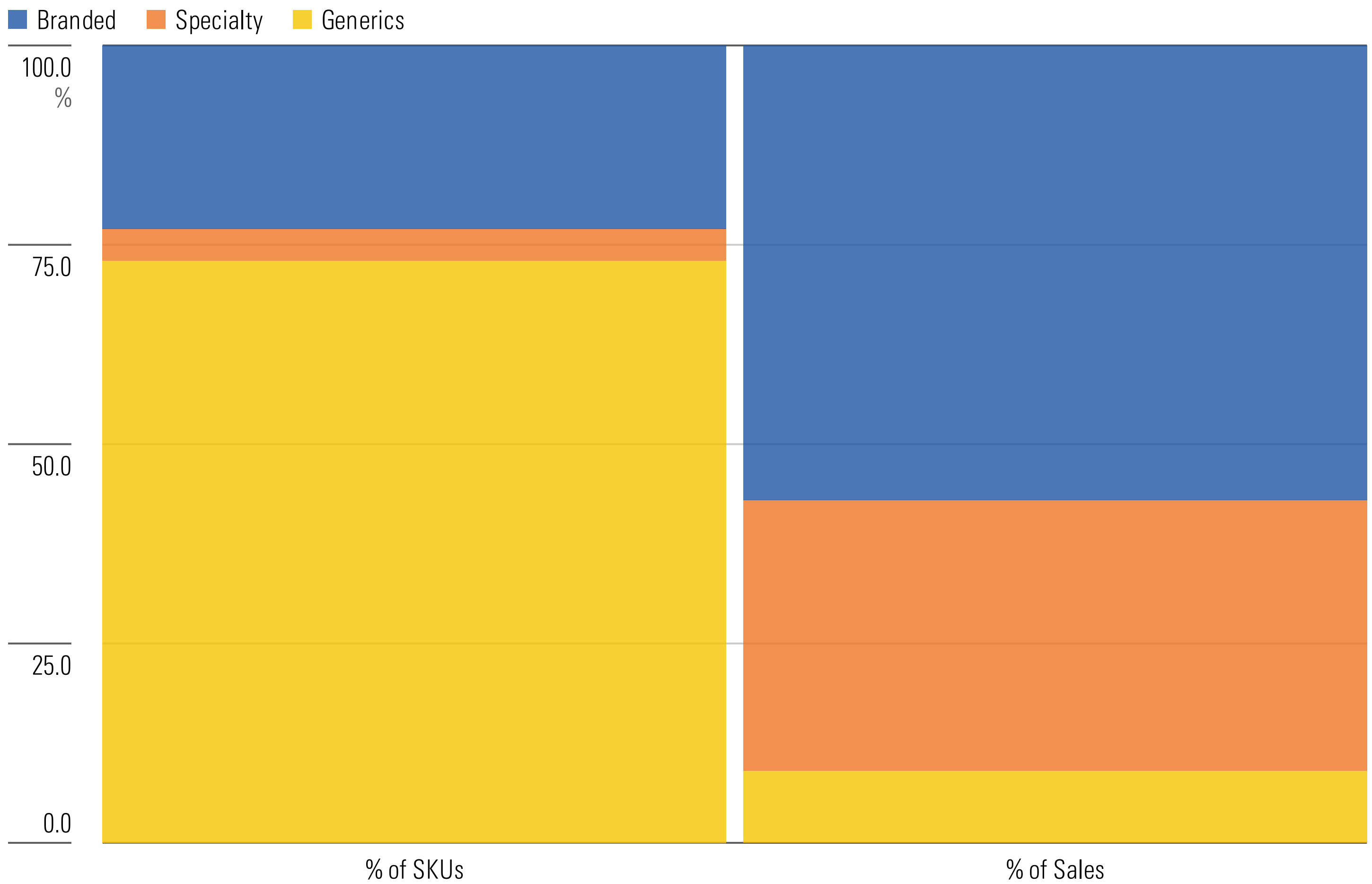
Source: Healthcare Distribution Alliance, Morningstar.

Specialty Drugs Have an Outsize Impact on Distributors Compared With Other Drug Types

Like branded drugs, specialty drugs have an outsize impact on drug expenditures and distributors' sales due to their high price tags. But distributors also see margin pressures from specialty drug distribution since their profits are narrowly tied to price and largely driven by fee for service.

Specialty distributors serve a wide network of healthcare providers, including independent physicians, hospitals, pharmacies, and homecare providers. We believe this offers opportunities to provide additional high-margin services. Distributors can unlock better economics from customers by offering services like third-party logistics, consulting, claims collection, and inventory management. We have seen the Big Three distributors expand their presence in this space in recent years.

Specialty Drugs Make Up Less Than 5% of Stock-Keeping Units but More Than a Third of Sales for Distributors

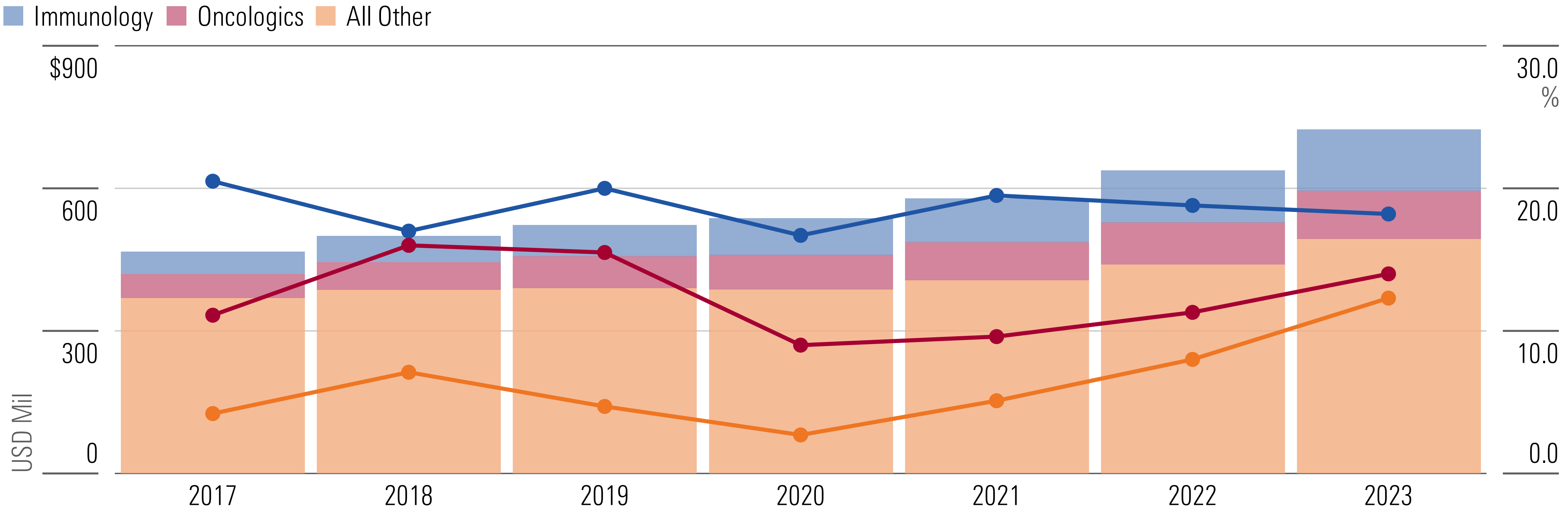


Source: Healthcare Distribution Alliance.

Immunology and Oncology Remain the Biggest Specialty Opportunities for Distributors

Spending on immunology and oncology collectively made up about 20% of the specialty market in 2017 but now makes up roughly a third. Both therapeutic areas have delivered faster growth over the last five years compared with the overall market, and we think this trend is likely to continue. New treatment launches should spur growth, and emerging biosimilars can offset some losses from key biologics going off patent. We believe this is a catalyst for the Big Three distributors focusing on these two therapeutic areas for recent investments.

Immunology and Oncology Grow Faster Than Overall Specialty Market



Source: Healthcare Distribution Alliance.

Distributors Have Bundled Services for Customers, Further Bolstering Switching Costs

Distributors have acquired assets or organically invested to create vertically integrated specialty pharmaceutical businesses. The Big Three distributors own both specialty distribution businesses and group purchasing organizations. This is a significant barrier for healthcare providers that want to purchase specialty drugs directly from manufacturers because they will not have the purchasing power to negotiate similar discounts as GPOs.

By acting as both a distributor and a GPO service provider, distributors have a close relationship with customers, which can help when offering additional services. Businesses like data insights, revenue cycle management, and reimbursement strategy support are higher-margin and offer opportunities for distributors to deepen relationships.

Each of the Big Three Distributors Has Unique Assets for Clinics, Hospitals, and Patients

	Cardinal Health	Cencora	McKesson
Specialty Distribution	Cardinal Health Specialty Pharmaceutical Distribution, Metro Medical Distribution	AmerisourceBergen Specialty Distribution, Besse Medical, Oncology Supply	McKesson Specialty Distribution
Specialty GPOs	VitalSource, Cornerstone Rheumatology, Acuity, Renal Purchasing Group, MosaicGPO Solutions	ION Oncology Practice Network, Nephrology Practice Network, Specialty Practice Network, Specialty Advancement Network	Onmark, PlasmaRx
Specialty Pharmacy	MMS Solutions Specialty Pharmacy	TheraCom	Biologics
Community Networks	Navista Network, Integrated Oncology Network	OneOncology	US Oncology
Analytics and Insights Business	NavistaTS, Advanced Practice Analytics	IntrinsiQ Specialty Solutions	Ontada
Inventory Management	RxID Select	OrderInsite (partner)	Lynx

Source: Morningstar. Peach for manufacturers; blue for clinics; yellow for providers and patients; purple for manufacturers and clinics.

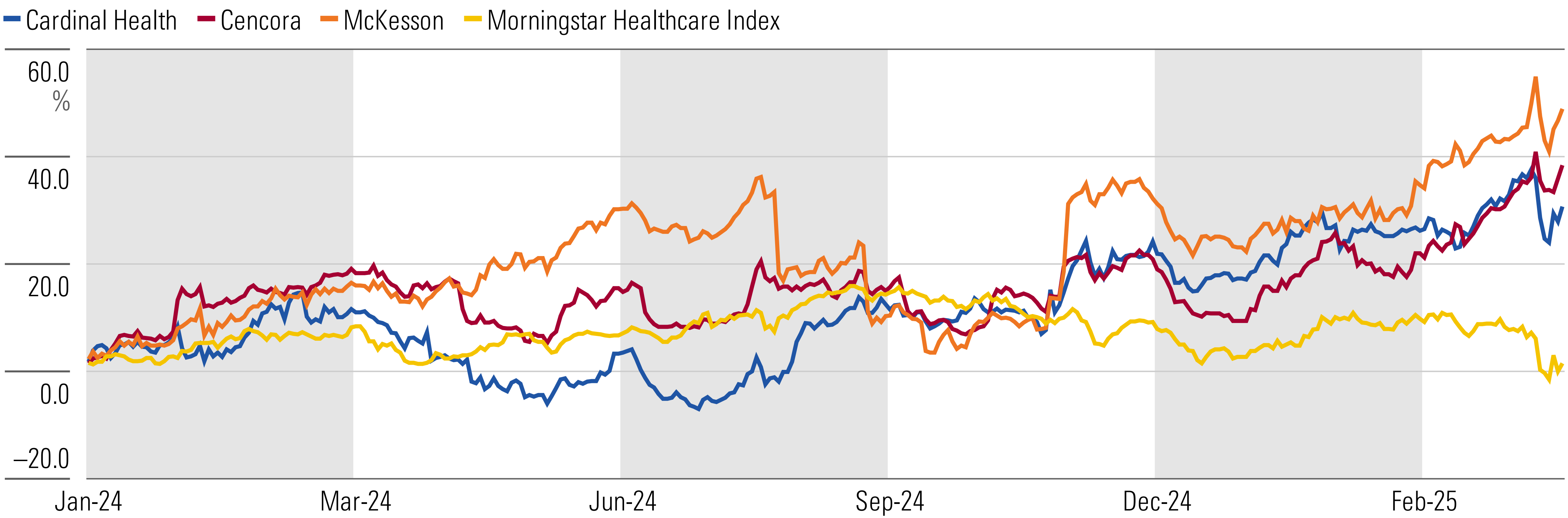
Outlook

New therapies boost sales, and biosimilars and specialty assets promote margin expansion.

Drug Distributors Have Significantly Outperformed the US Healthcare Index

We think the market has rallied behind the US drug distribution industry recently due to strong GLP-1 contributions, increasing specialty asset investments, and relative safety against tariffs and macroeconomic downturn. Since the beginning of 2024, the Big Three distributors have delivered an average 40% gain compared with the Morningstar Healthcare Index's 1%.

All Three Big Drug Distributors Have Delivered Solid Gains Compared With Overall Healthcare Sector

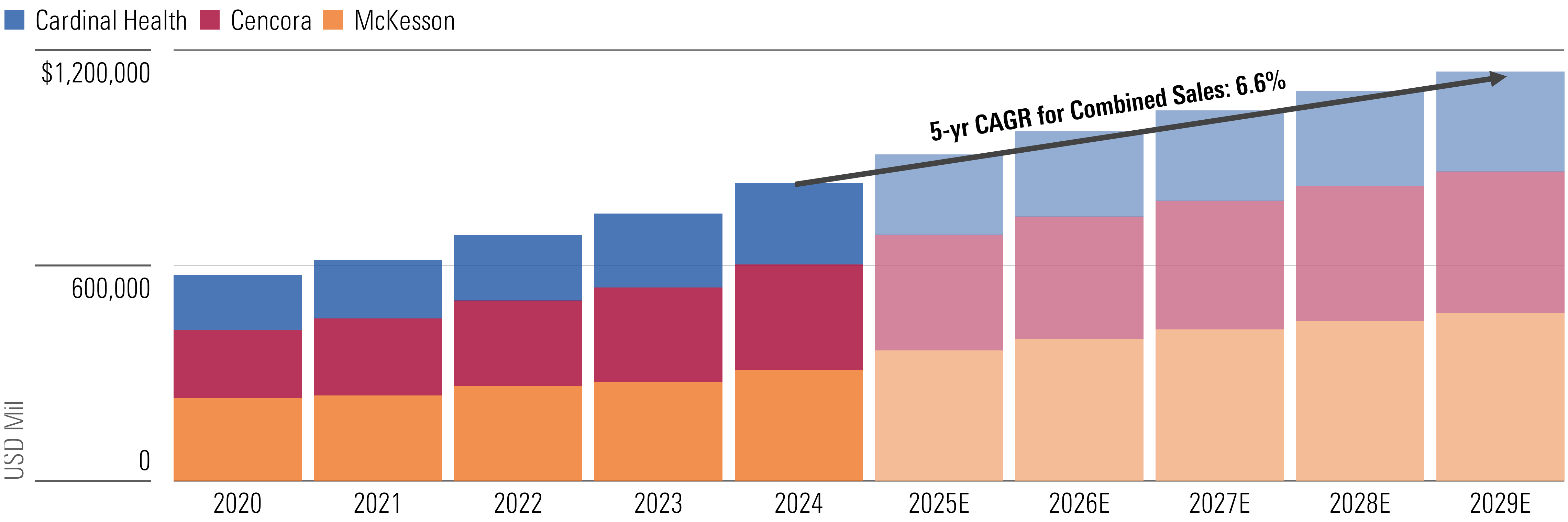


Source: PitchBook. Data as of April 11, 2025.

We Expect All Three Distributors to Enjoy Mid-Single-Digit Growth Through 2029

We forecast that the Big Three distributors will continue to control the market over the next five years. We think they are all well-positioned to enjoy macro trends, including an aging population, growth in prescription expenditures, and increasing access to healthcare. These drivers should provide a nice tailwind to distributors' top lines and help them achieve mid-single-digit compound annual growth rates over the next five years.

We Forecast Combined Sales for Big Three Distributors to Surpass $1 Trillion by 2028



Source: Morningstar.

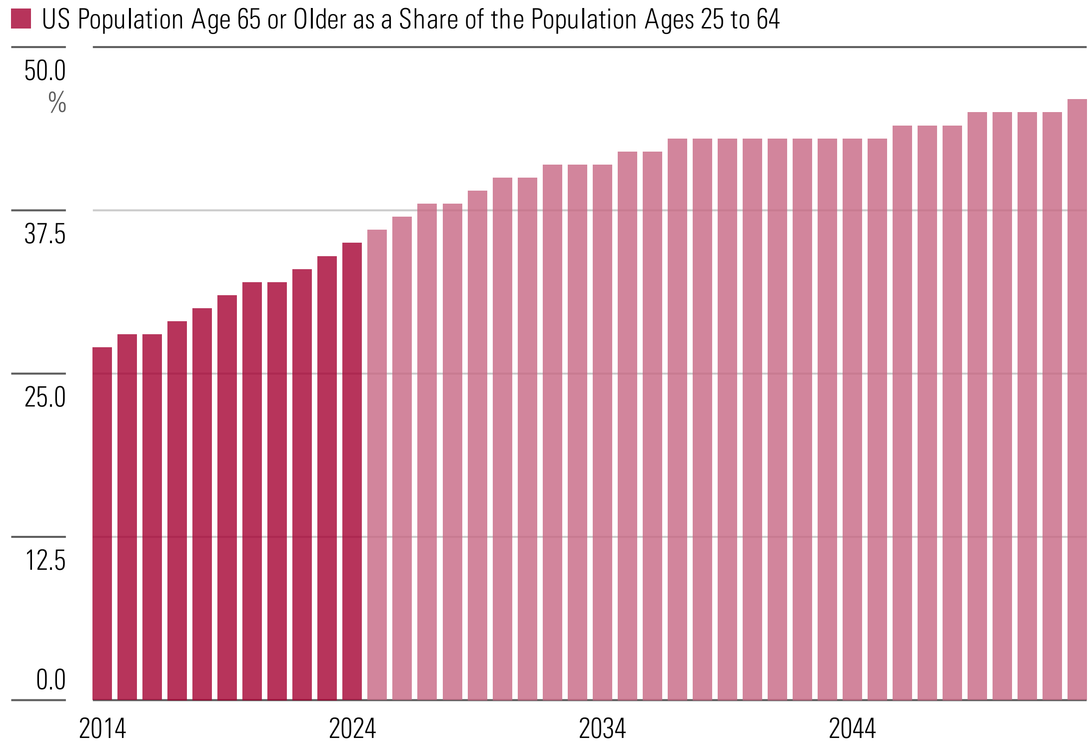
Aging Population Should Drive Demand for Pharmaceuticals and Boost Distributors' Sales

The US population has been aging for decades, and this trend shows no sign of reversal in either the near or long term. While Americans 65 and older make up less than 20% of the population today, they account for over a third of total drug expenditures. As the US population continues to age, we believe prescription volume is likely to rise accordingly because this age group ranks highest in drug utilization. This could provide a solid tailwind for distributors' sales.

Americans 65 and Older Make Up Largest Portion of US Drug Expenditures

Age Group	%
0-18	9.00
19-34	12.00
35-44	10.00
45-54	13.00
55-64	19.00
65+	37.00

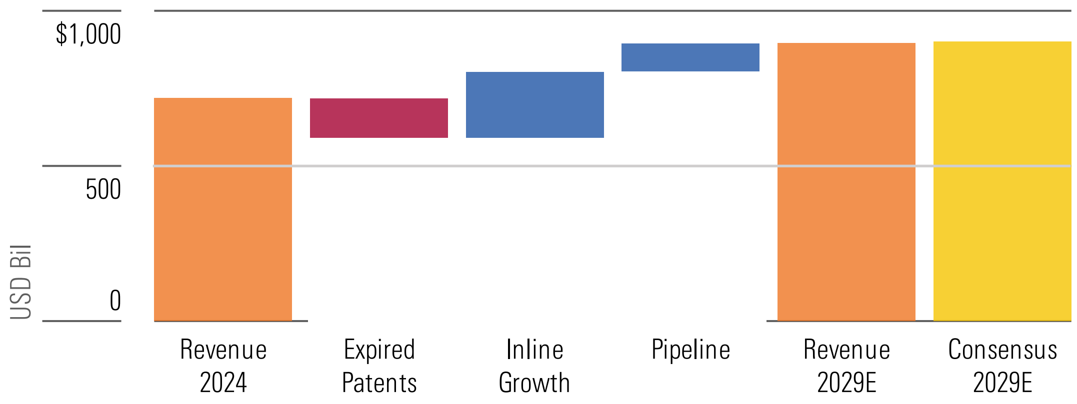
US Population Poised to Grow Older Over the Long Term



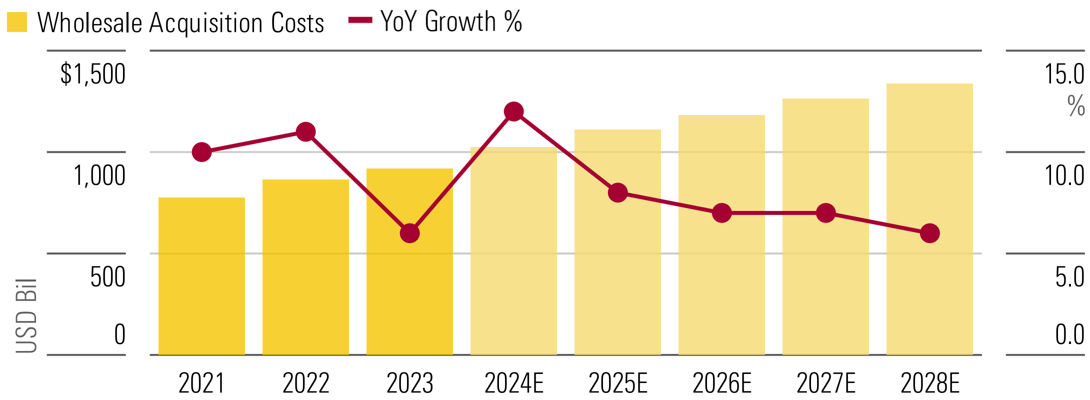
Source: KFF analysis of 2021 Medical Expenditure Panel Survey data, Congressional Budget Office.

Branded Drug Sales Growth and Continued List Price Hikes Propel Growth for Distributors

Growth of Approved Drugs and Pipeline Assets to Offset Patent Losses



List Price Growth Is Slowing but Still Rising



Plenty of Tailwinds to Negate Headwinds From Expiring Patents

Patent losses are one of the biggest hurdles for biopharma manufacturers, but they also affect distributors, which will likely lose certain top-line contributions as branded drugs expire and go generic. Key blockbuster drugs that are likely to go generic in the next five years include Keytruda, Eylea, Prolia/Xgeva, and Tysabri.

Nevertheless, we expect manufacturers and distributors to offset these losses through the growth of other already-approved therapies and pipeline assets. Areas like oncology, rare diseases, and neurology remain pivotal for near-term pipeline assets to drive growth in the industry.

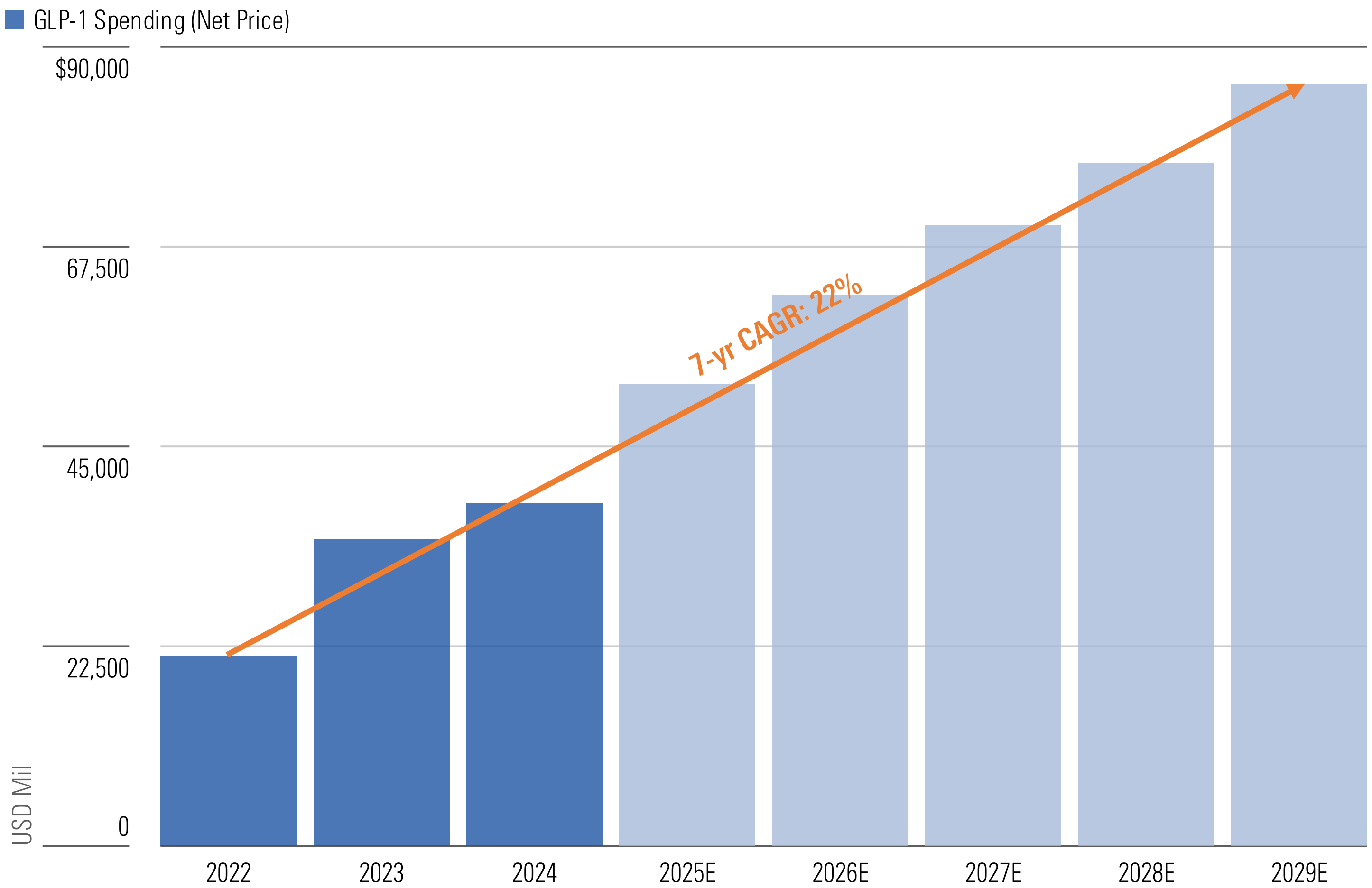
Drug Pricing on Close Watch but Not a Material Worry for Distributors

Rising healthcare costs for Americans have put a spotlight on drug price inflation and were a major driver behind the Inflation Reduction Act. This regulation caps price increases across Medicare channels, or manufacturers must pay rebates for price increases above the rate of inflation. It also significantly reduces prices on older blockbuster drugs. While this creates certain headwinds for distributors' sales, we think new drug launches will be more than enough to drive mid-single-digit growth for the three big distributors over the next five years.

Source: Morningstar, IQVIA. Top chart includes branded drug sales at AbbVie, Amgen, AstraZeneca, Bayer, Biogen, BioMarin, Bristol, Gilead, GSK, J&J, Eli Lilly, Merck, Novartis, Novo Nordisk, Pfizer, Regeneron, Roche, and Sanofi.

Continued Adoption of Obesity Drugs Will Fuel Distribution Sales, but It Comes With Costs

US Spending on Obesity Drugs Remains a Key Growth Driver for Distributors



GLP-1s were first approved to treat diabetes but are now seeing stellar growth as novel obesity therapies. They have been one of the main recipients of attention in the biopharma market since 2022, and their impact has trickled down nicely to drug distributors. All three big distributors have delivered double-digit growth in their distribution businesses in recent quarters, and we estimate that GLP-1s collectively contributed about one fourth of the growth. This is impressive given that spending on obesity drugs in 2024 made up less than 10% of US prescription spending.

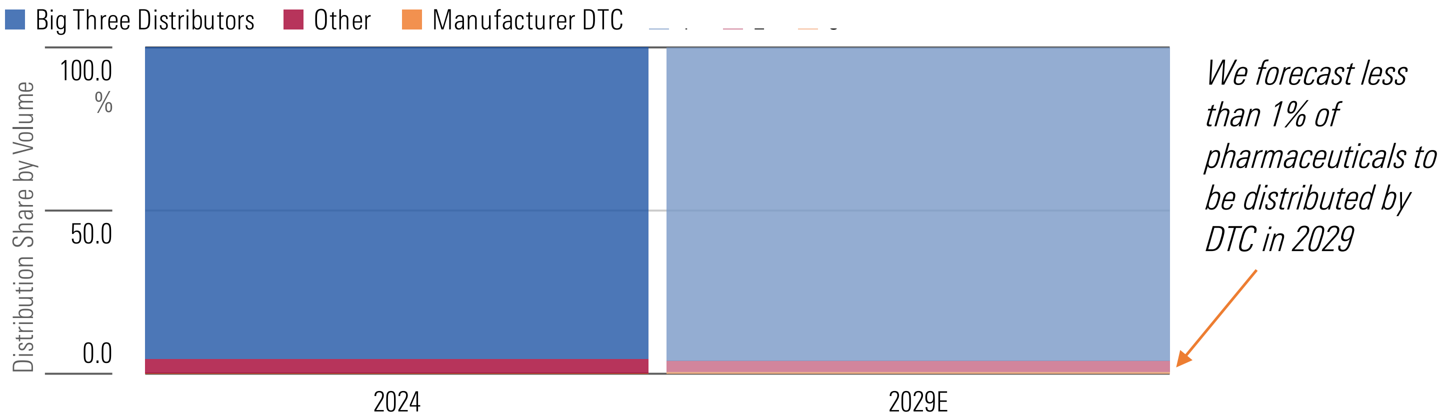
One downside of GLP-1s is their margin headwinds. Since they are branded drugs that are predominantly dispensed by the largest pharmacies and require special delivery methods like cold-chain handling, they carry lower margins than generics. Segment operating margins have declined sequentially for all three distributors, reaching their lowest level of the past three years. However, we still view GLP-1s as a net positive to distributors because they boost the top line and offer opportunities for distributors to sell other high-margin services like prior authorization solutions.

Source: Morningstar.

Direct-to-Consumer Offerings from Manufacturers Do Little to Diminish Distributors' Importance

DTC Channel Allows Manufacturers to Bypass Distributors and Connects With Patients

More Than 99% of Pharmaceuticals Still Go Through Distributors



Recently, some manufacturers have developed online direct-to-consumer channels to offer certain medications and bypass distributors. Eli Lilly launched LillyDirect in January 2024, Pfizer launched PfizerForAll in August 2024, and Novo Nordisk launched NovoCare in March 2025. Patients can get a selection of insulin and diabetes management drugs on LillyDirect and NovoCare, and covid vaccines on PfizerForAll.

We believe DTC channels originated so that manufacturers can raise awareness of their key products and meet demand. This is especially true for GLP-1s since many faced shortages in 2024 and couldn't fulfill the growing demand. In our opinion, DTC channels allow Lilly, for example, to offer another option for patients to receive medication while also controlling supply.

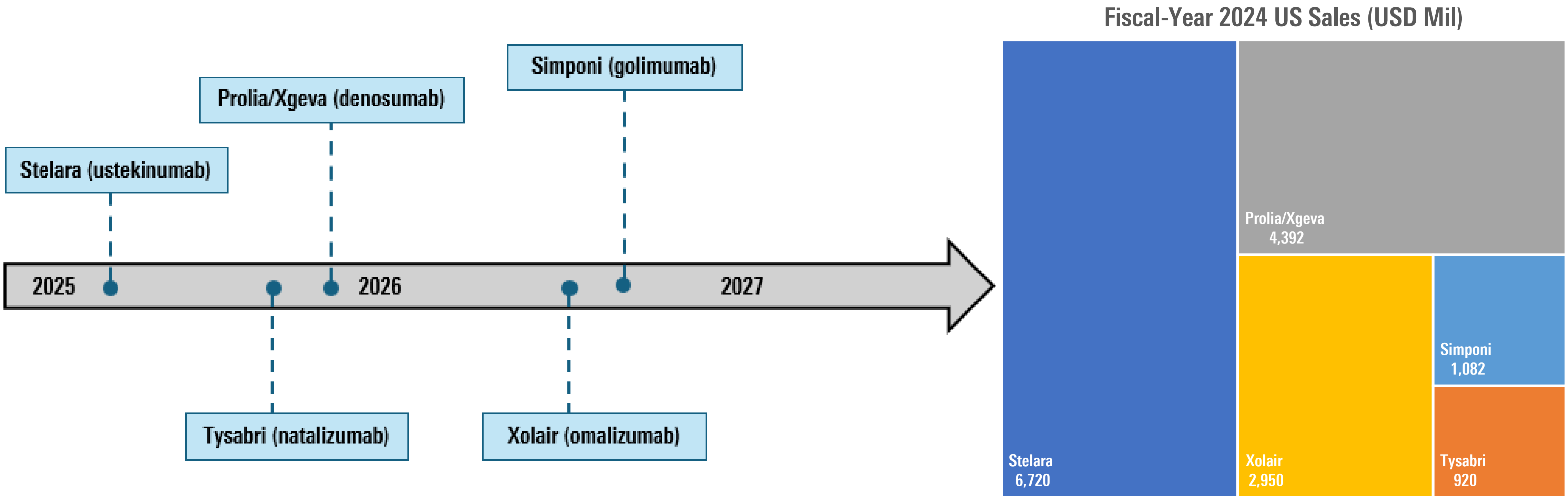
Despite manufacturers working to reach patients directly and avoid relying on distributors for certain medications, we don't anticipate these efforts having a transformative impact on the overall drug distribution industry. Limitations on offerings, inconvenience in transferring prescriptions, and the ingrained nature of retail and mail-order pharmacies all make us skeptical that DTC channels will disrupt distributors.

Source: Morningstar.

Patent Losses in Blockbuster Branded Drugs and Biologics Should Spur Generic and Biosimilar Growth

We believe several blockbuster biologics will go off patent and see biosimilar substitution over the next five years. While their adoption varies by therapeutic area and has been poor for certain drugs (Humira, for example), biosimilars on average make up over 50% of the market within three years after their initial launch. Because biosimilars generally show better margins for distributors compared with biologics, we think future biosimilar launches could provide tailwinds to the top and bottom lines of the Big Three distributors.

Anticipated Biosimilar Launches Look to Be Fruitful for Distributors



Source: Morningstar, company filings.

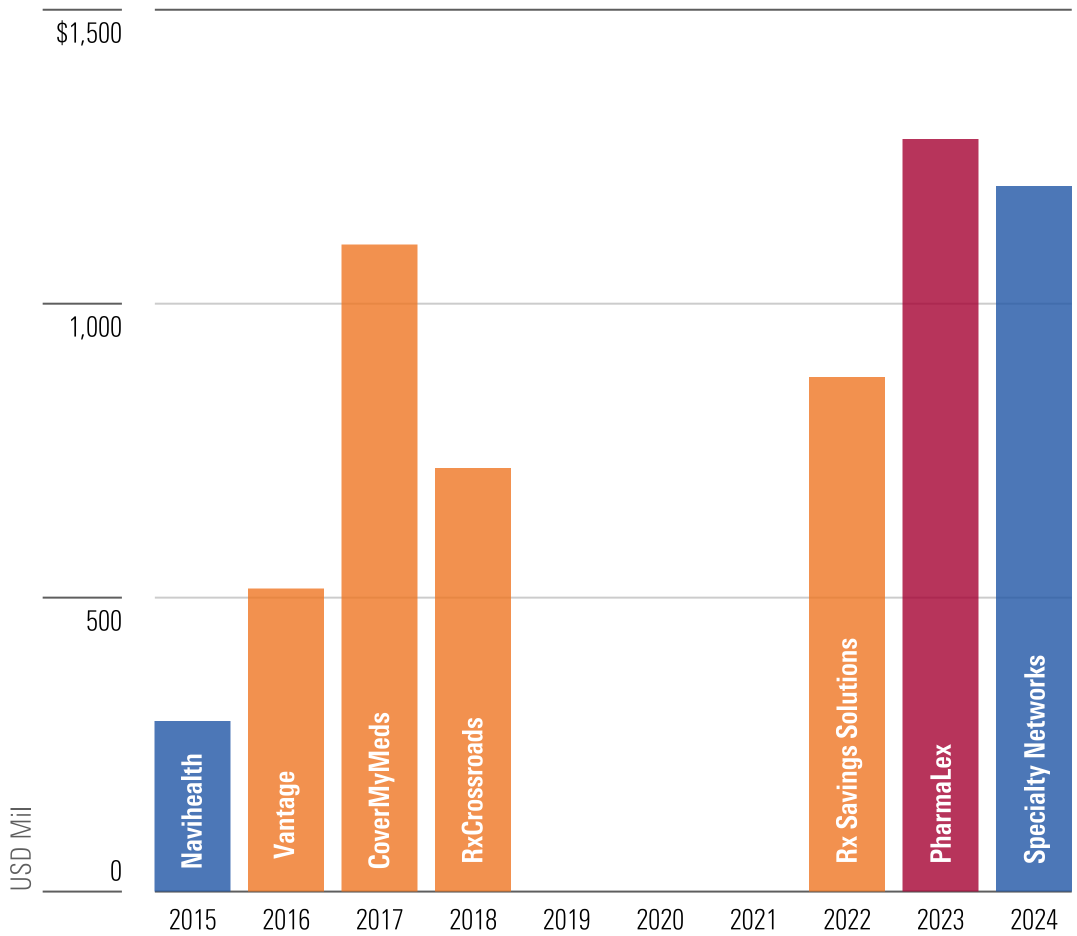
Distributors Have Invested to Bolster Their Portfolios of High-Margin Services

Due to adverse drug pricing dynamics that have weighed down margins over the past eight years, the Big Three distributors have focused on building up their portfolios of high-margin services through acquisitions. Since they have close and longstanding relationships with a diverse network of customers, distributors are well-positioned to offer services that go beyond simple distribution; they can extract higher margins through offerings like insights and analytics, data, and workflow management.

In recent quarters, the Big Three distributors have utilized the growth of GLP-1s and benefited from their high-margin assets. A surge of new patients wanting GLP-1 prescriptions has driven demand for electronic prior authorization, a technology that makes the process of medication prior authorizations more efficient. This business drives higher margins than the distribution of GLP-1s and has offset certain margin headwinds for the Big Three distributors.

Notable Acquisitions of Technology and Insights Service Assets in the Past Decade

Cardinal Health is blue, Cencora is red, and McKesson is orange.



Source: Morningstar. Year refers to acquisition announcement.

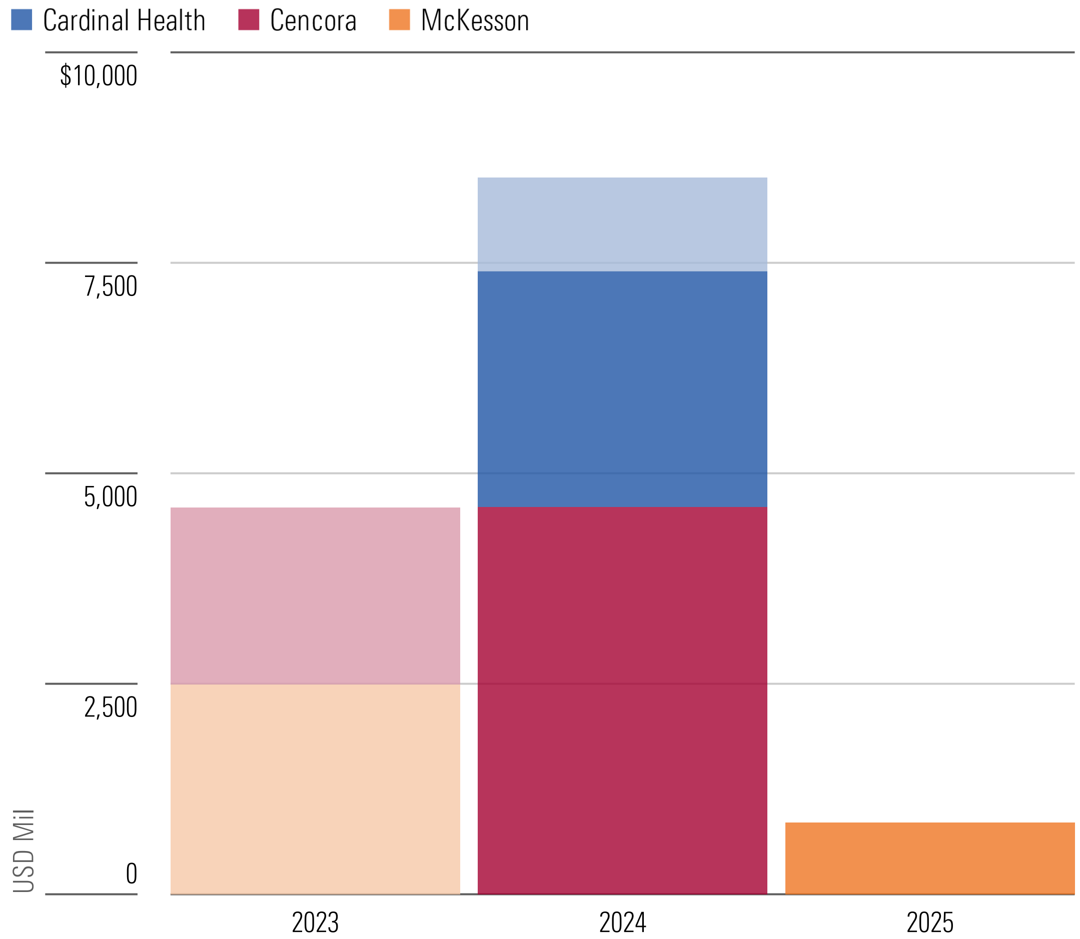
Management Service Organization Investments Begins to Tick Up Outside Oncology

Distributors historically looked for assets to bolster their oncology offerings. McKesson purchased US Oncology in 2010, Cencora formed a joint venture with a private equity firm to acquire OneOncology in 2023, and Cardinal acquired Integrated Oncology Network in 2024. This strategically makes sense because oncology has been the fastest-growing specialty therapeutic area over the past decade.

However, it looks like key oncology assets in the marketplace have all been picked up or are fetching a premium because just over the past 12 months, the three distributors have all ventured outside of oncology to bolster their specialty assets in different therapeutic areas. In November 2024, Cardinal announced its intention to acquire a gastroenterology management services organization, or MSO, and Cencora, a retinal specialty MSO. Similarly, McKesson in February 2025 acquired an ophthalmology MSO. We expect more deals outside of oncology as distributors either fight for the same therapeutic areas or establish their dominance in unique areas.

Key MSO Acquisitions Shift Focus From Oncology to Other Areas

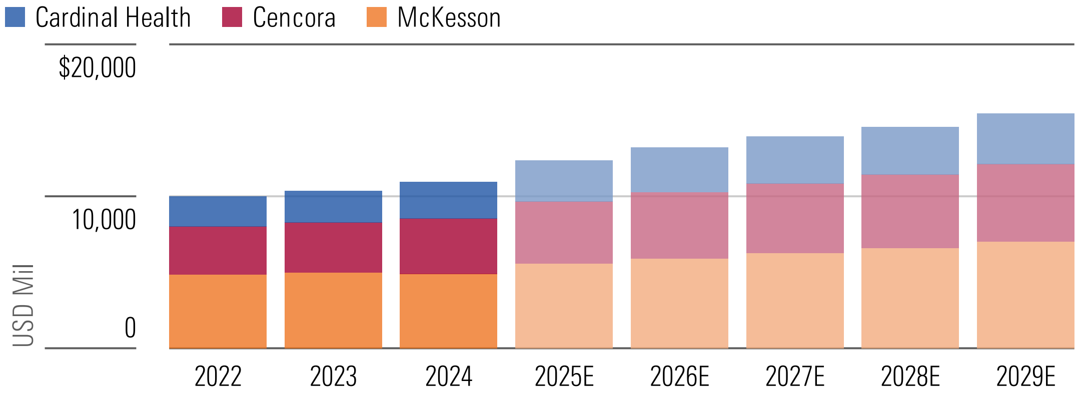
Light shade: oncology, Bold: ex-oncology.



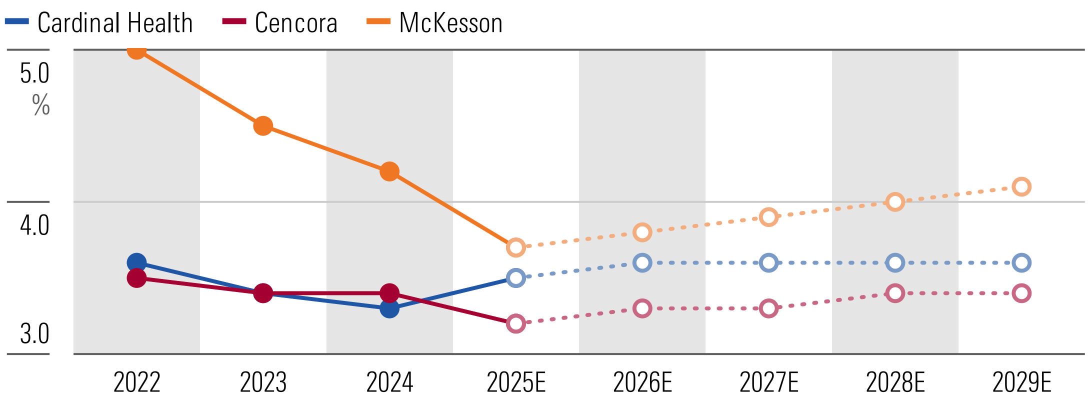
Source: Morningstar, company filings. Data as of April 11, 2025. Year refers to acquisition announcement.

We Forecast Slightly Improving Margins From Biosimilar and Specialty Asset Uptake

Adjusted EBIT to Grow at a Modest Pace Over the Next Five Years



Gross Margins to Improve but Unlikely to Recover to 2022 Levels



Against the backdrop of adverse drug pricing dynamics, distributors have seen their margins diminish year over year since the mid-2010s. However, we are starting to see conditions improve in the marketplace and anticipate certain tailwinds that could reverse the trend in the near term.

New Biosimilar Launches Provide Favorable Mix

As many blockbuster biologics go off patent and their volume is replaced by biosimilars, we think distributors will see margins improve. Like generic drugs, many versions of biosimilars for one reference drug are usually manufactured by different companies (Amgen, Sandoz, Teva). This affords more pricing power to distributors compared with a branded drug marketplace; distributors can ask for higher discounts from manufacturers and extract better margins. However, we don't anticipate gross margins rebounding to 2021 levels because biosimilars deliver lower gross margins than generics, and new specialty and branded therapies continue to pose headwinds.

Investments in Specialty Assets to Pay Off

We think the vertically integrated specialty asset portfolios that the Big Three distributors have amassed can provide tailwinds to their margins. We think distributors are well-positioned to offer higher-margin services like revenue cycle management, payer negotiation support, and inventory management, especially as their oncology networks grow via additions of new community clinics.

Source: Morningstar.

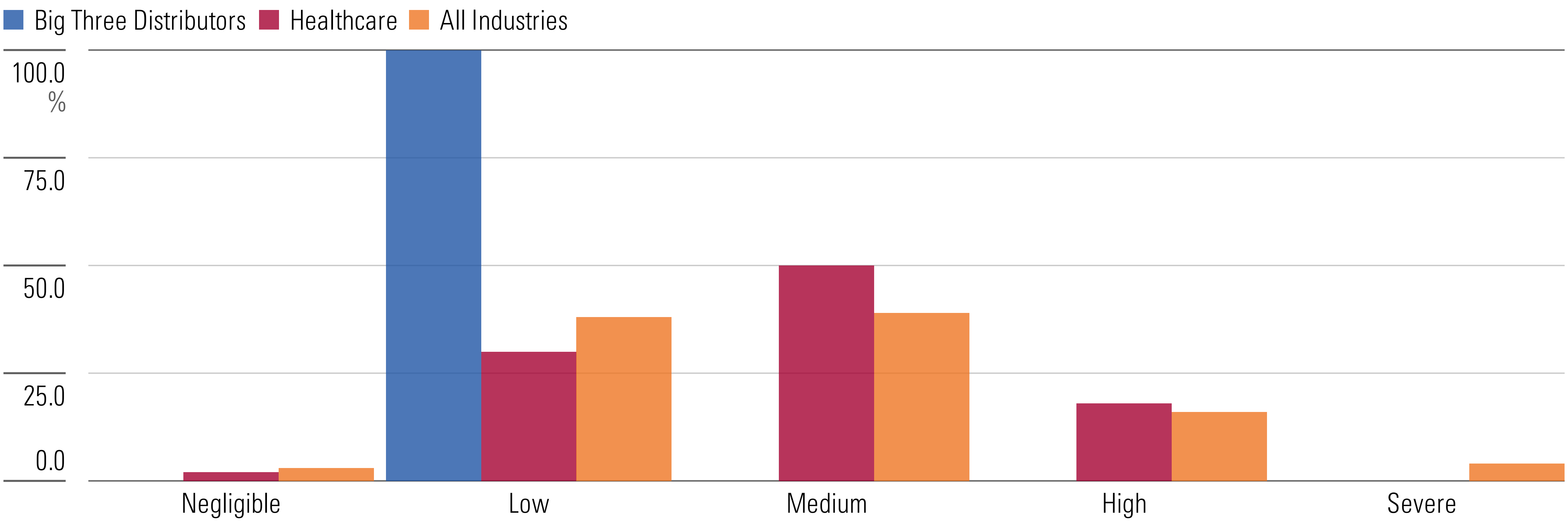
ESG Snapshot

Distributors face lower ESG risks compared with other healthcare firms.

All Three Big Drug Distributors Have Low ESG Risk Ratings

We think Cardinal Health, Cencora, and McKesson are relatively exempt from material environmental, social, and governance risks. The only noteworthy risk is in product governance, because the products they transport must meet strict safety and quality guidelines. Besides the major opioid litigation (see next slide), there have not been any material events in the past five years that suggest the Big Three distributors have violated regulatory guidelines surrounding pharmaceutical delivery.

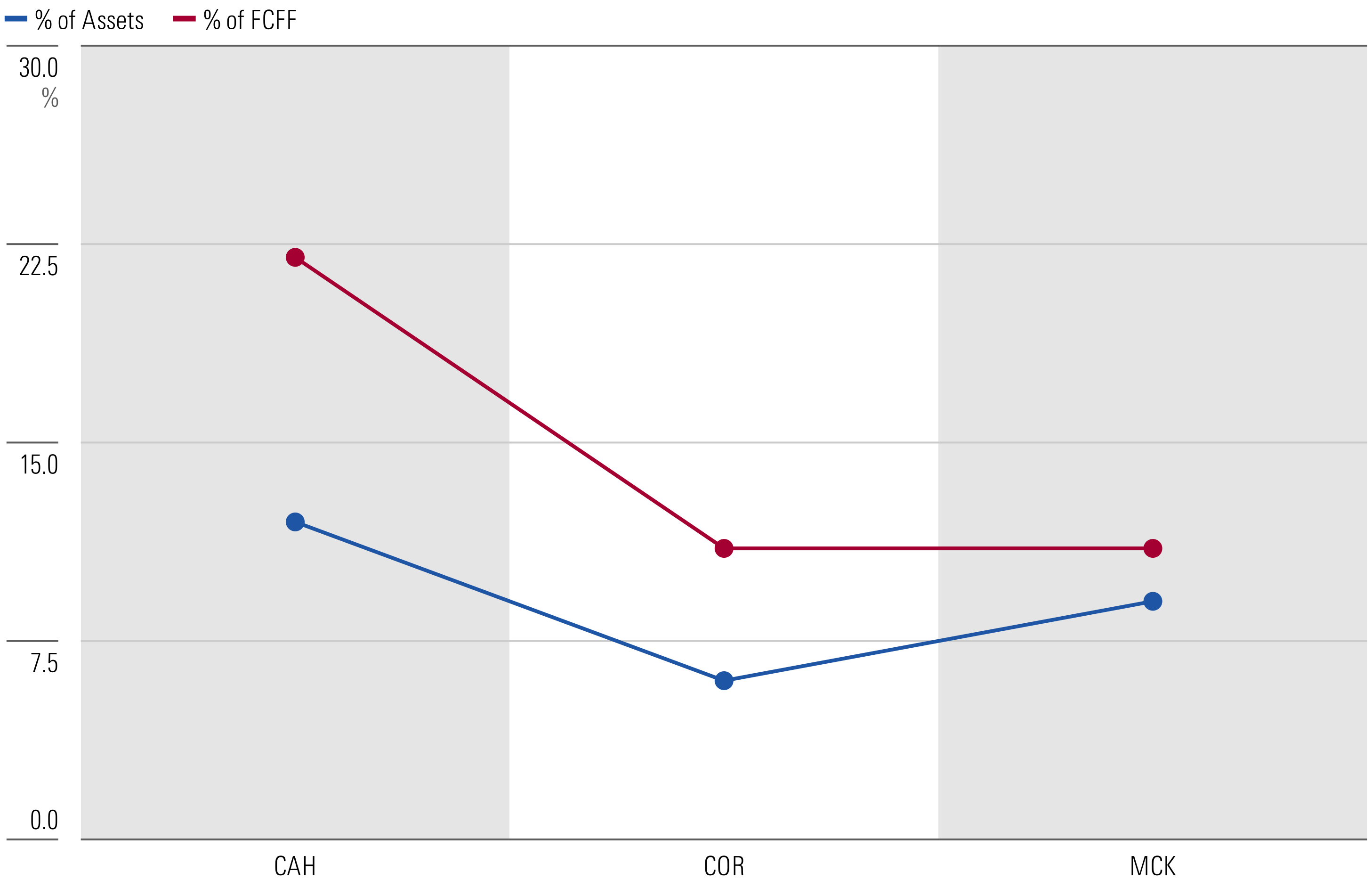
Drug Distributors Less Vulnerable to ESG Risks Than Others in Healthcare and All Industries



Source: Morningstar Sustainalytics. Data of October 2024.

Uncertainty Around Opioid Lawsuits Largely Behind Us, Future Risks Manageable

Estimated Annual Payments Related to Opioid Lawsuits Make Up Less Than 25% of 2024 FCFF



Lawsuits against the Big Three distributors related to the distribution of opioid pain medications started to be filed in 2017. In April 2022, the distributors settled with 48 out of 49 eligible states as well as the District of Columbia to resolve all opioid litigation. This resulted in the distributors having to pay a combined $20.3 billion over the next 18 years: approximately $6.0 billion for Cardinal Health, $6.4 billion for Cencora, and $7.8 billion for McKesson.

We do not expect any additional risks from this because there is no more outstanding litigation related to this issue, and the distributors have already taken the litigation charges in their income statements.

Source: Morningstar, PitchBook, company filings. FCFF = free cash flow to the firm.

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