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McKESSON
Empowering Healthcare

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To Our Stockholders:

I am pleased to report to you that McKesson Corporation delivered industry leading financial performance in Fiscal 2005, our fifth consecutive year of improving financial results. For the fiscal year ended March 31, 2005, McKesson had revenue growth of 16%, to $80.5 billion. We had strong growth in pharmaceutical distribution, our largest segment, despite the slowest market growth in more than a decade. McKesson's growth was driven by two primary factors. First, we signed a large new contract with the Department of Veterans Affairs, which we implemented in May 2004. Second, one of our largest customers, Caremark, acquired a competitor and won a large contract to supply pharmaceuticals to federal employees. In both cases, Caremark directed the business to us.

We were also pleased to announce a proposed settlement of our consolidated securities class action related to the January 1999 acquisition of HBO & Co. This settlement agreement still must be approved by the Court. Excluding the $810 million after-tax effect of the securities settlement and reserve for additional remaining restatement cases, McKesson earned $2.19 per diluted share.

As we began Fiscal 2005, the level of our compensation from pharmaceutical manufacturers was largely dependent on price inflation. When pharmaceutical price increases fell far below the historical pattern for the second quarter, McKesson's earnings fell substantially short of expectations in that period. We rapidly developed and executed a plan to smoothly transition agreements with pharmaceutical manufacturers to deliver acceptable and more predictable compensation in future years while maintaining acceptable compensation during the current year. As Fiscal 2005 financial results indicate, our plan was successful. As expected, pharmaceutical price increases returned to historical ranges late in calendar 2004, and our higher-margin generics programs continued to expand faster than the market, both of which generated strong profits in the third and fourth quarters. By the middle of Fiscal 2006, a substantial majority of our compensation from pharmaceutical manufacturers will no longer be contingent on the timing or magnitude of price increases.

McKesson Medical-Surgical Solutions segment grew in line with the market, adjusting for the loss of one large acute care customer. A lack of flu vaccine supply and a litigation charge reduced operating profit compared to the prior year, which masked the continued progress we are making in improving the results of this business. We had strong growth and margin improvement at McKesson Provider Technologies along with greatly increased software bookings that create additional opportunity for margin improvement as we implement these solutions in coming periods.

Our evolving pharmaceutical manufacturer agreements, together with continued focus on supply chain efficiencies, drove record operating cash flow of $1.5 billion, our third consecutive year of strong performance on this important metric. Over the past three years, cumulative cash flow has exceeded $3 billion. We have been conservative with our balance sheet. We ended the year with $1.8 billion in cash compared with $1.2 billion in debt. Given McKesson's strong balance sheet and cash flow, we believe our securities litigation liability can easily be funded once we have received the required court approval. We now have tremendous financial flexibility to continue to create shareholder value.

Business Segment Review

Pharmaceutical Solutions

In addition to our program to secure more predictable compensation from pharmaceutical manufacturers, we initiated sales force programs and incentives focused on improving customer profitability. We are charging more rigorously for specialized services that previously may have been provided as part of the overall relationship. Using a new enterprise-wide information system, we capture more detailed insights into individual customer accounts and determine how we can improve the profitability for both the customer and the company. We were successful generating additional profit last year, and plan to continue these programs in fiscal 2006.

On the operations side, we continued to achieve significant improvements in both quality and productivity. Since fiscal 2000, the U.S. pharmaceutical distribution business has added $40 billion in sales, with almost no change in total headcount. During that same time, we have driven average annual volume per continental distribution center from less than $500 million to $1.6 billion. As a result of systematic and strategic programs such as the Six Sigma approach we have implemented to improve our processes the past six years, our quality measures are much-improved. Our customers tell us that McKesson has the best service in the industry. For example, in mid-April, we accepted an award from Wal-Mart as Supplier of the Year, the second time in four years we have been singled out for quality performance by a customer known for its demanding standards. In Fiscal 2005, we renewed all of our large accounts that were due to expire and we are beginning to see signs of sell margin stabilization.

We continue to gain momentum in the Payor business. Our software to help payors screen and adjudicate claims remains the market leader, and last fiscal year we acquired a smaller competitor, IntelliClaim, which strengthens our market position. We are developing extensions to the basic product line and believe that we have a sustainable, high-margin growth business. We are also making steady progress in the disease management side of the company. While extremely promising longer-term, this business is currently in the investment stage. McKesson is the leading provider of disease management support to state Medicaid agencies. During fiscal 2005, we launched disease management programs to service the Medicaid populations in the states of Texas and Pennsylvania, increasing to nine the number of states to whom we already provide this service. We were also recently awarded a Medicare Disease Management contract.

In summary, we believe that we are making great progress in our Pharmaceutical Solutions segment. We have strong, value-based relationships across our balanced mix of customers, many of whom are leaders in their market segments. We believe this will enable sustained revenue growth at market rates. We have gained a significant amount of predictability in the compensation we receive from manufacturers. We manage our operations to deliver efficiencies to McKesson and a high level of service to our customers. We are well-positioned to benefit from market dynamics such as the Medicare Modernization Act and increased use of generics. This is a great business.

Medical-Surgical Solutions

Medical-Surgical Solutions revenue growth was strong in the alternate site segments of nursing homes and physician offices. In the fourth quarter of Fiscal 2005 we recorded growth in the acute care segment for the first time in the year following the loss of the HCA business in the fourth quarter of Fiscal 2004. Our acquisition of Moore Medical on April 1, 2004, significantly strengthened our position in the more rapidly growing alternate site market and provides a platform to expand our offering of higher margin products.

The profit improvement progression we experienced in this business coming into the fiscal year flattened. A number of items, such as a $7 million litigation charge and a lack of flu vaccine supply mask the progress we continued to make. We have strengthened our position with the McKesson Brand Product offering which drives incremental margin for McKesson and better quality and value for our customers. The Optyx cost-analysis technology we launched this year improved our competitive position in the acute care sector. While the acute market is our most difficult market, through Optyx, private brands and our supply chain information offering, we have the ability to change the game and deliver unique value for our customers.

Provider Technologies

McKesson Provider Technologies revenues were up solidly for the year. Software and software systems revenues were especially strong, driven primarily by an increase in automation systems revenues and implementations of clinical software solutions. Software bookings reached a record level for the full year, driven by continued strong demand for clinical solutions.

Our hospital customers are rapidly moving to digital technology to reduce their dependence on paper and film. As a result, medical and document imaging solutions continue to be among our top-selling software products. When combined with our physician portal, these systems drive both strong operational benefits and more rapid physician adoption of IT, setting the stage nicely for the rest of our Horizon Clinicals solutions, which includes Horizon Expert Orders, our computerized physician order entry and decision support system.

A major objective for Provider Technologies entering the year was to accelerate the speed of its clinical implementations, to drive revenue recognition and accelerate the sales process with other customers. We gained momentum over the course of the year. For example, our first implementation for a complex multi-facility customer, IASIS, required seven months. The next 14 installations for this customer are scheduled to be completed in four months each. Our industry leading Horizon Expert Documentation solution for nursing productivity is now being installed and deployed hospital-wide in six months. At Duke University, rather than implementing Horizon Expert Orders with small groups of physicians at a time, we planned a comprehensive go-live for the entire cardiology department. We installed that department and quickly moved on to additional areas. An aggressive hospital-wide rollout is now underway.

The combination of McKesson Information Solutions with in-patient automation to form McKesson Provider Technologies at the beginning of Fiscal 2005 was well executed and enhanced our positioning with hospital customers. Our unique solution for medication safety which integrates software, robotics, cabinets and bedside scanners enables us to take advantage of the increasing pressure on hospitals to reduce errors and help them meet new requirements for bar coding medications. PakPlus-Rx packaging sales were also up significantly, growing 233 percent quarter over quarter in the fourth quarter and 95 percent year over year. McKesson's PakPlus-Rx service now packages 135 million bar-coded, unit-based doses per year. In particular, we have changed the view of cabinets from ancillary equipment in the hospital to part of an intelligent, software-driven solution to reduce medication errors. Sales of AcuDose-Rx unit-based cabinets doubled quarter over quarter and were up 52% for the year. These results underscore the power of our One McKesson aligned selling approach in the market.

I am extremely pleased with the progress we continue to make returning McKesson Provider Technologies to a leading role in the healthcare information technology market. Over the past five years, we have streamlined the organization to align our capabilities more closely to the needs of our customers. We have rebuilt and then strengthened relationships with customers and refined our implementation processes to help improve the quality and timeliness of our installations, which should accelerate the recognition of our revenues.

We made a series of product acquisitions that complemented our internal development programs to deliver more innovative solutions than any competitor. In the Top 20: 2004 Best in KLAS year-end report, 12 McKesson Provider Technologies products were ranked among the top three for their categories, more than any other company. Two McKesson solutions were named ''Best in KLAS'' for their No. 1 rankings, while two others were named Specialty Niche Category Leaders. I believe that we have the clearest vision of our customers' needs and the most aligned strategy for realizing that vision. We are absolutely at the right place at the right time with this business. McKesson is poised to help transform healthcare.

Outlook for Fiscal 2006

Looking back over the past five years, we have delivered industry leading performance while rebuilding our infrastructure, strengthening our balance sheet, enhancing our management team and creating stronger, value-based relationships with our customers and supplier partners. During that period, revenues have more than doubled, earnings per share have more than tripled, excluding the shareholders' litigation charge, and we have generated more than $3 billion of cumulative cash flow from operations.

We strengthened the balance sheet but didn't starve the organization at the expense of future growth. Over the past five years, we spent more than $1 billion on R&D for innovative new products and services designed to support our customers as they re-engineer the cost and quality of healthcare, and another $1 billion in improvements and enhancements to our infrastructure to deliver greater efficiencies. As a result, we are well-positioned for sustained growth driven by both an increase in the absolute level of healthcare demand, and the expectations of healthcare consumers that the quality of healthcare they receive is the best that can be delivered.

The market factors I identified in my letter last year continue to be strong positive drivers for our business. Government and consumer pressure continues to mount to improve the quality of healthcare while reducing the cost. The 2004 elections drove much of the national healthcare agenda in Washington last year, and McKesson was actively involved. With more than 50 candidates or elected members visiting McKesson facilities and customer sites, we had significant opportunities to educate policymakers about the vital role we play in the delivery of healthcare.

As the January 2006 implementation of the Medicare Modernization Act draws nearer, the focus intensifies on such issues as drug pricing and drug importation. In our continuing effort to promote choices for seniors and highlight the important role of retail pharmacy, we successfully launched our Medicare-approved Rx Savings Access card, which now has more than 10% of the market among the 70+ discount cards available to eligible seniors. To date, this card has saved 240,000 enrollees more than $75 million in drug costs. Our leadership in promoting drug savings for seniors has not gone unnoticed by the Bush Administration. During a visit to St. Louis last summer, President Bush was photographed with a senior citizen as she waved her McKesson Rx Savings Access card and lauded the reduced cost of her medicines. By awarding McKesson a chronic care demonstration project in Mississippi, the Administration further recognized our proven track record in providing disease management services designed to improve outcomes and reduce costs in nine state Medicaid programs. The HHS Task Force on Importation released its final recommendations to Congress last December. The conclusions reached by the Task Force reflect McKesson's recommendations to maintain the safety, security and efficiency of the pharmaceutical supply chain.

Last spring, President Bush appointed Dr. David Brailer as the National Coordinator for Healthcare Information Technology. Shortly thereafter, HHS Secretary Thompson invited me to chair the industry panel at his unprecedented Secretarial Summit on HIT last summer. This opportunity allowed us to highlight McKesson's leadership in HIT and to encourage all those in healthcare to put the patient at the center of care and accelerate the adoption of critical technology solutions. Our recommendations were further delineated in our response to Dr. Brailer's request for comments on the establishment of a National Health Information Network.

The President continued to stress his support for electronic medical records and HIT in his State of the Union address. The relationships we have built with key members of the House and Senate have led to opportunities for us to showcase our ambulatory and hospital technology solutions on Capitol Hill, at customer sites and at our Vision Center here in San Francisco. We continue to be actively engaged in bipartisan discussions in the House and Senate to craft legislation that will address many of the barriers to rapid adoption of HIT.

If it sounds to you like McKesson today is an exciting place to be, you're right. We sit in the middle of the fastest-growing and most rewarding segment of the American economy. My thanks to our employees for their hard work and tremendous commitment to our success, to our customers for their loyalty and cooperative spirit, to our supplier partners for their collaborative approach to our mutual goals and to our shareholders for their continued support.

I'm very pleased with the results we delivered in Fiscal 2005. I believe that as a result of our new agreements with pharmaceutical manufacturers and the general progress we have made across the business, we enter the new fiscal year more confident than ever about our prospects. Over the past five years, McKesson has reached a position of leadership in pharmaceutical distribution, clinical software solutions, hospital automation, payor software and disease management. Our medical-surgical business is a leader in the alternate site sector. All of these markets have very favorable dynamics driving growth, so we are equally confident about the long-term prospects for our business. I look forward to continued strong performance in Fiscal 2006.

John H. Hammergren
Chairman and Chief Executive Officer

Special Note Regarding Forward-looking Statements

Certain matters discussed in this letter constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities and Exchange Act of 1934, as amended. Some of the forward-looking statements can be identified by the use of forward-looking words such as ''believes,'' ''expects,'' ''may,'' ''will,'' ''should,'' ''seeks,'' ''approximately,'' ''intends,'' ''plans,'' ''estimates'' or ''anticipates,'' and the negative of those words or other comparable terminology. The discussion of financial trends, strategy, plans or intentions may also include forward-looking statements. Forward-looking statements involve risks and uncertainties that could cause actual events and results to differ materially from those projected. These include, but are not limited to, the factors discussed in the company's Fiscal 2005 Annual Report on Form 10-K that accompanies this letter.