Shoppers Drug Mart: A sickly stock that's poised for recovery

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Shares in the pharmacy chain have been down since mid-January, but here are six reasons to give it a second look

Buying good companies experiencing temporary setbacks can be a profitable strategy. For those who can handle some risk, Shoppers Drug Mart is worth a look.

Shares of Canada's largest pharmacy chain have been under the weather since Jan. 18, when most provinces and territories announced plans to cap prices of six popular generic drugs at 18 per cent of the brand-name price, down from 25 to 40 per cent previously.

It was the latest regulatory blow for Shoppers as governments try to rein in drug costs, and it sent the shares down 7 per cent over four days. Shoppers has been battling regulatory headwinds for a few years now, which explains why the stock is trading below where it was at this time in 2010.

But some analysts say the selling has been overdone and think Shoppers has plenty of upside. Here are six reasons that Shoppers' sickly stock could be poised for a recovery.

1. The market overreacted

Irene Nattel, an analyst with RBC Dominion Securities, estimates the latest cut to generic drug prices will shave just 11 cents per share (or about 3 per cent) from Shoppers' 2013 earnings, rising to 16 cents per share in 2014 when the lower prices will be in place for a full year.

That's hardly a reason to panic, considering Shoppers generates more than half of its sales from non-pharmacy items.

"The environment is clearly challenging, but [Shoppers's] size and scale make it far more able to adapt than independents," Ms. Nattel said in a note in which she reiterated her "outperform" rating and price target of $47.

2. Tough times spell opportunity

Independent pharmacies will be hit harder, because they generate about 80 per cent of sales from prescriptions. That could accelerate the trend of independents closing shop and selling their prescription lists to Shoppers.

When Shoppers buys prescription lists, "they are acquiring customers at no additional fixed costs. It's very lucrative," ***Veritas Investment Research*** analyst ***Kathleen Wong*** said in an interview. She also has a "buy" rating and $47 intrinsic value estimate on the shares.

3. The dividend is growing

Even as it battles regulatory changes, Shoppers generates plenty of free cash flow and has raised its dividend annually since 2005 (with the exception of 2009, during the financial crisis). The next dividend hike is expected on Feb. 7, when Shoppers reports fourth-quarter results. Bloomberg estimates Shoppers will boost the dividend to $1.14 annually, from $1.06 – an increase of 7.5 per cent.

4. Results might surprise

The severe flu season is expected to have boosted antiviral prescriptions and driven more traffic through the front of the store for over-the-counter medications and other products, said Kenric Tyghe, an analyst with Raymond James. As a result, he said same-store sales growth could be stronger than expected. Mr. Tyghe, who estimates fourth-quarter same-store sales rose 3.4 per cent compared with a year ago, has an "outperform" rating and $48 price target on the shares.

5. The (demographic) trend is your friend

Although regulatory risks remain, Shoppers stands to benefit as the population ages and people live longer. Seniors are the fastest-growing demographic group and are expected to double as a percentage of the population over the next 20 years. "Older humans tend to take as many as five times the number of prescriptions as adults under 38 years old," said Brian Yarbrough, an analyst with Edward Jones, who has a "hold" on the shares.

On the non-prescription side, Shoppers is generating growth from high-margin cosmetics and fragrances, and its Optimum rewards program – with about 10 million members – is a huge plus. What's more, the company is rolling out more private-label products, including its own Sanis line of generic drugs, that should help to increase margins.

6. The valuation is attractive

Shoppers trades at a multiple of about 13.6 times the average 2013 earnings estimate of $3.04 a share – a reasonable multiple for a company with an entrenched market position, strong brand name and good growth opportunities. The yield of 2.6 per cent is modest, but the dividend will almost certainly grow, rewarding patient income investors.