CVS: The Picture of Health

S&P can find few weak links in this chain, whose successful integration of Eckerd positions it to ride the general increase in drugstore sales

CVS seems to be in the bloom of health. Aided by its July, 2004, acquisition of 1,268 Eckerd drug stores, CVS (CVS; recent price, $31) has grown to become the largest U.S. drugstore chain, based on store count, with over 5,400 stores in operation as of June, 2005. Standard & Poor's believes the integration of the Eckerd stores provides the company with a significant opportunity to accelerate earnings growth over the next few years. We think other factors should also drive CVS's growth in coming periods, including continued expansion of the company's store base and strong comparable-store sales growth.
We view the drugstore industry positively, based on our view of favorable demographics and an improving pipeline of new drugs, and believe the company is well positioned to achieve its stated goal of 15% long-term earnings growth. The stock carries S&P's highest investment recommendation of 5 STARS, or strong buy.

Pharmacy operations are critical to Rhode Island-based CVS' success, as they accounted for 70% of sales in 2004. We expect growth of payments by third-party managed-care providers under prescription-drug plans to continue to pressure margins. In 2004, third-party sales accounted for over 93% of total pharmacy sales. The company expects its pharmacy operations to continue to be a key focus, reflecting its ability to succeed in the rapidly growing managed-care arena, and its ongoing purchase of prescription files from independent pharmacies.

**GENERAL OFFERINGS.** Front-end operations -- i.e., the sale of merchandise other than pharmaceutical products and related items -- benefit directly from the success of pharmacy operations, as shoppers who come in to have a prescription filled often make a front-end purchase. In 2004, front-end store sales accounted for 30% of total sales. Additionally, front-end products typically provide wider gross margins than pharmacy sales. CVS offers a broad array of general merchandise, including OTC drugs, greeting cards, film and photofinishing services, beauty aids and cosmetics, seasonal merchandise, and convenience foods.

Pharmacy benefit management (PBM) services are offered to managed-care and other organizations. These services include mail-order pharmacy services, specialty pharmacy services, plan design and administration, formulary management, and claims processing. CVS's PBM business operates under the PharmaCare Management Services name and ranks as the fourth-largest full-service PBM in the nation. CVS covered approximately 30 million lives (the industry term for covered parties) as of January, 2005.

Stores are located primarily in strip shopping centers or freestanding locations, with a typical store ranging in size from 8,000 to 13,000 square feet. Most new stores being built range in size between 10,000 to 13,000 square feet and typically include a drive-through pharmacy. The company believes that about half of its store base was opened or remodeled over the past five years. As of December, 2004, net selling space for its retail and specialty pharmacy drugstores was 43.5 million square feet.

**ECKERD DIGESTION.** We project revenue growth of about 20% in 2005, driven by 10% to 12% growth from the acquisition of Eckerd drug stores, 3.5% square footage growth, and same-store sales growth of 6% to 8%.

We believe the acquisition of Eckerd's drug stores provides CVS with a significant opportunity to accelerate earnings growth over the next few years. The acquisition will have added a net 1,101 stores to its store base by the end of 2005, including our projection for the closure of 174 acquired Eckerd stores. Initial savings are being achieved through the elimination of personnel and purchasing synergies. We expect additional benefits to be achieved through improved shrink (losses from theft of merchandise) control and increased in-store productivity levels.
We expect CVS to experience improved productivity within the acquired Eckerd stores for the next few years. The potential for improvement is large, in our view, with sales per square foot of $356 in the former Eckerd stores, vs. $834 in core CVS stores. To help unlock this potential, the company's strategy is to increase convenience by expanding store hours, enhance customer service by increasing employees' presence in the stores, and apply its inventory-management systems to improve inventory control.

SALES SPURT. Despite the distraction major acquisitions can produce, we expect CVS to maintain its new store growth strategy. For 2005, we're projecting organic retail square footage growth of approximately 3.5%, reflecting the net addition of 125 new stores, including the closure of about 50 stores. Additionally, the company plans to relocate approximately 100 to 125 stores.

Relocations to freestanding locations remain an important part of the company's strategy, as only 55% of stores were freestanding as of January, 2005. Historically, freestanding stores have generated improvements in customer count and net sales, as they're larger and, we think, more convenient than those located in shopping centers.

The company looks to increase sales within core CVS locations by improving the convenience of its stores and beefing up merchandising and customer service. We project same-store sales will grow 6% to 8% in 2005, reflecting 3% to 5% front-end sales growth and 7% to 9% pharmacy sales growth. To drive front-end store growth, the company is focusing on differentiating its merchandising.

CVS has signed exclusive contracts to sell beauty-care products with companies such as Lumene, Avene, and Vichy. The company has also highlighted the exclusivity of the CVS shopping experience by being first to market with disposable digital cameras and disposable video cameras.

HAPPY SHOPPERS. In an effort to improve customer service, CVS is investing in information systems to reduce the number of out-of-stock items, lower costs, and increase operating efficiency. We think the company continues to be innovative in technology investment, becoming the first chain drug and national retailer to accept contactless methods of payment (where the customer's credit card doesn't need to be handed to the cashier or swiped, and, in most instances, a sales receipt doesn't need to be signed) in order to speed up checkout times. Additional technology investments are expected to help store managers better track performance within stores and improve in-store scheduling and planning, while highlighting stores that may need additional support.

Improved service levels are also helping drive pharmacy sales growth. CVS hopes to lock in customer loyalty through improvement of the shopping experience. By focusing on the reduction of customer waiting times, we believe the company is improving customer-satisfaction levels. Pharmacists' face-to-face time with customers has also improved, as CVS increases pharmacy technician training.

Pharmacy operations are also benefiting, in our opinion, from favorable long-term trends that include an aging population, a strong drug pipeline, and expanded health-care coverage for Medicare participants. With the average number of prescriptions per person increasing significantly with age, we believe the company is well positioned to improve, with operations in 74 of the top 100 U.S. retail markets and holding the No. 1 or 2 share in 51 of those markets.

MEDICARE BENEFITS. Drugstores should also benefit as new drugs enter the market, as the average price for drugs continues to rise. The average prescription price rose 6.8%, to $63.59, in 2004, significantly faster than the 2.7% growth rate for inflation in 2004. Despite sluggish growth in new drug approvals since 2003,
S&P projects an acceleration of approvals by the FDA after 2005.

The launching of the Medicare Part D drug benefit on January 1, 2006, may provide a growth opportunity for CVS. With 42 million beneficiaries expected to be covered, we expect CVS to experience increased store traffic and demand for pharmacy services. Although third-party customers generate narrower margins than cash customers, the anticipated increase in volume should offset any impact, in our view.

We expect overall margin trends to improve as a result of acquisition synergies, including increased purchasing power and larger market scale, as well as benefits from higher generic drug sales and better cost management stemming from the inventory and pharmacy efficiency programs mentioned above. Generic drugs carry wider margins than their branded counterparts, while selling at significantly lower sales prices.

SOUND EARNINGS. We see the net result from increased generic drug sales as a positive. With more convenient locations, improved customer-service levels, and more face-to-face time with pharmacists, we believe CVS will benefit, since drugs generating over $60 billion in sales are expected to lose patent protection between 2005 and 2009, up from $11 billion between 2000 to 2004.

We view the quality of CVS’s earnings to be above average. Our 2005 and 2006 Standard & Poor’s Core EPS estimates of $1.34 and $1.51, respectively, reflect the negative impact from stock-option expense. In our opinion, the divergence between CVS’s Core and operating EPS is in line with similar drug companies in our coverage universe.

Our 12-month target price of $35 is based on both our p-e and discounted cash flow analyses. In our view, the integration of Eckerd stores provides a significant opportunity to accelerate earnings growth over the next few years. As a result, our p-e analysis applies a 22.5 times multiple, based on 1.5 times our projected long-term growth rate of 15%, to our 2006 EPS estimate of $1.55, resulting in a share value of $35. This multiple is only slightly ahead of CVS’s five-year average historical forward p-e of 21.4 times.

POTENTIAL SIDE-EFFECTS. The 22.5 times multiple also represents a 20% discount to the company’s closest peer, less than the five-year historical average discount of 38%, reflecting our view of a recovery from difficulties with a prior acquisition, the smooth integration of Eckerd stores, the resumption of an internal growth program, and favorable industry trends. Our analysis of discounted cash flows suggests an intrinsic value of about $34.

We believe CVS’s corporate-governance practices are above average compared to peers. Performance of the board of directors is reviewed annually, and a majority of the company’s directors are independent. Additionally, the full board is elected annually. However, shareholders don’t have cumulative voting rights in election of the directors.

Risks to our recommendation and target price include potential changes to Medicare and/or Medicaid reimbursement rates in an effort to reduce prescription-drug costs. While the reduction of reimbursement rates in one state may not significantly affect the company’s earnings, we think the cumulative impact from multiple states may lead to a significant reduction in results.

The continued growth of mail-order pharmacies and changes to pharmacy benefit plans requiring maintenance medications may lead to decreased demand for retail-pharmacy services. Rising competition from other retail formats -- such as supermarkets, mass merchandisers, membership clubs, and Internet companies --
may also lead to decreased demand. Finally, a slowdown in the rate of introduction of new prescription drugs is likely to have a negative impact on pharmacy growth. However, S&P projects an acceleration in new drug approvals following 2005.

Analyst Agnese follows shares of drug retailers for Standard & Poor's Equity Research Services

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