Shoppers Drug Mart Shareholders Received a Windfall

Financial Evaluation of Loblaws bid for Shoppers Drug Mart (December 2013)
The Weston Mosaic

MB8005 – Finance

March 30, 2015

Team #1

Tzvi Aviv 500671456
Josh Makuch 500475770
Adey Farah 502282206
Gokul Sundararajan 500662296

Table of Contents

Introduction

Shoppers Drug Mart (SDM) and Loblaws are two iconic Canadian retailers that have been a part of the Canadian retail landscape for generations. Toronto pharmacist Murray Koffler founded Shoppers Drug Mart in 1962. He believed that a national pharmacy organization could still retain personalized service for each local community. At the cornerstone of the SDM business strategy is the Associate Concept, one in which each individual pharmacy retains some independent ownership, authorities and duties but falls under the umbrella of a corporate entity. The company also has branches that deal as medical clinic pharmacies (Shoppers Simply Pharmacy), specialty luxury beauty boutiques (Murale boutiques), and Home Health Care stores, that are involved with selling and servicing assisted-living devices and more. In its 53 years, the company has grown to become the leading drug store retailer in Canada with 1,253 stores. The last decade has seen Shoppers expand heavily into "front of store" items, like food and cosmetics, to supplement pharmaceutical sales. As well, their Optimum points card (introduced in 2000) is the largest and most successful loyalty program in Canada (Shoppers Drug Mart, n.d.).

In 2012, Shoppers saw steady growth in many of its markets, amongst them prescription sales (5% up in volume and up 2.8% in revenues), and same-store prescriptions sales climbed 2.3% (Shaw, 2012). Further, non-pharmacy sales rose 5.5% to $1.43 billion per quarter. Interestingly, SDM seem increasingly more focused on its retail business since average prescription values continued to decline due to an increase switch from expensive brand name drugs to cheaper generic drugs (Shaw, 2012). SDM continued their steady growth, and as such made them an attractive proposition for the Loblaws acquisition. In 2014, Loblaws offered a friendly takeover of SDM for $12.4 billion, to make it a wholly owned subsidiary of Loblaw Companies Limited (Shoppers Drug Mart A, 2014). Our financial analysis of SDM will demonstrate that the Loblaw's offer of $61.54 per SDM share was optimistically based on nearly best case scenario for dividend growth in SDM and therefore was unanimously received by shareholders.

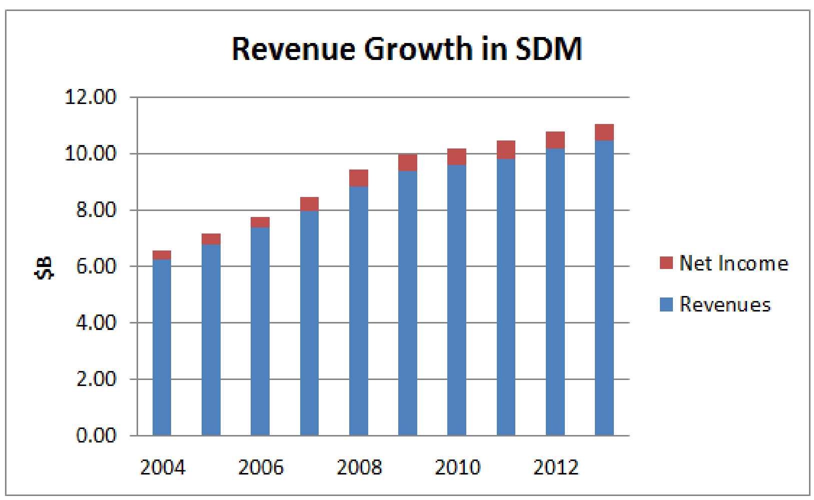
Accounting and cash flows analysis for SDM

Revenue and growth

As of December 28, 2013, there were 1253 SDM's stores and the company recorded consolidated sales of approximately $11.1 billion which is an increase of 2.6% over the previous year (**Figure 1**). Same-store-sales had an increase in growth of 1.9%, indicating that most of growth in revenues is from same-store sales and 38% of growth is due to new stores expansions. Profit margins for SDM are consistent at about 5.5% over the last decade, in the accepted range for the retail sector. Despite the modest growth in sales, Year-over-Year EBITDA were down by 1% in 2013 and 2012 (**Exhibit 1**). In 2013 the company distributed $430 million to its shareholders and repurchased 4.5 million shares that cost them $200 million. The consolidated earnings remain unchanged after 2011 which implies that there is no visible growth financially within the company. Despite the steady revenues, the dividends growth rate shows an increasing trend year over year.

Cash flow analysis

Figure 1: Revenues and net income for SDM (2004-2013).



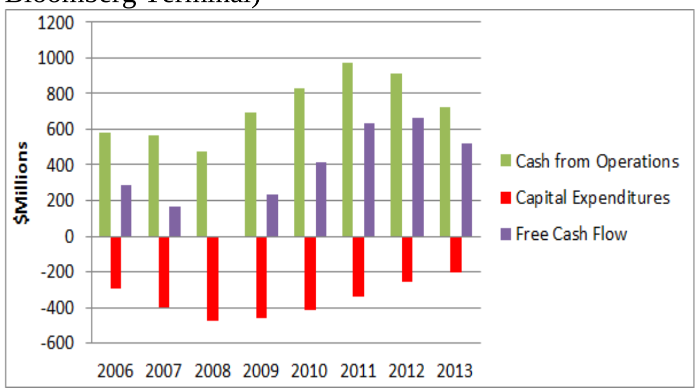
Cash flow from operations has increased year over year from 2008 to 2011, with a strong financial performance of the company until 2011 (**Figure 2**). The decline in cash from operations from 2011 to 2013 is a reflection of the decline in EBITDA in those years (**Exhibit 1**). Capital expenditure has decreased consistently since 2008, which suggests that stalled growth in SDM started back in 2009. Free cash flow is positive and averages $0.6B over the last three years, indicating an overall healthy business with growth struggles as indicated.

Problem Statement

In 2013 Loblaws offered $12.4 billion cash-and-shares acquisition of SDM. With 201,307,618 common shares, this offer is valuing SDM at $61.5 per share. The current (December 2013) market price of SDM share is $57.6 and dividends are growing, although net earnings of SDM decrease. Should SDM shareholders accept or reject the deal?

Establishing parameters for evaluation of SDM stock

Figure 2: Cash flows for SDM (2006-2013). (Source: Bloomberg Terminal)



For a dividend yielding company the dividend growth model can be utilized to estimate stock price and future yields from the stock to estimate the value of the stock to shareholders. The dividend growth model assumes that shareholders value mainly growing dividends distributed by the company as a cash-flow to infinity. The mathematics of the formula (P=D/(r-g)) were derived by Gordon and Shapiro (1956) to describe the interdependencies of current stock price (P), expected dividend (D), growth rate (g) and profit rate (discount rate, r). The current stock price of SDM is known, and the next dividend can estimated from previous dividends data. The Gordon model is very sensitive to the rate of growth and the discount rate. Possible ranges of growth rates and discount rates for SDM will be discussed separately below. Subsequently, several scenarios for revenues for shareholders over the next three to five years will be discussed.

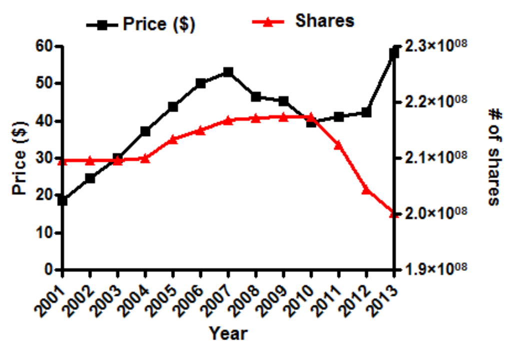
The growth rate of SDM is in the range of 2% to 8%. Future cash flow for SDM shareholders will depend on the financial benchmarks of the company. Comprehensive forecast for SDM can be obtained from observing the growth in multiple financials measurement. Examining the growth in the dividend stream over the past five years reveals an average growth of **5.80%**. The most recent trend observed in the past three years is even higher at 8.22% (**Table 1**). It is important to examine also accounting growth rates of earnings and revenues to determine the sustainability of the growth in dividends. Since the Gordon model requires an estimate of future growth in dividends, if the growth in dividends does not reflect the economic realities of the company or its market, this can serve as a red flag for the relevance of the Gordon model.

Table 1: SDM Annual Growth in dividends, EPS and revenues

YoY (%)	Dividends	EPS	Revenue
FY2013	7.55	3.74	2.56
FY2012	6.00	4.26	3.09
FY2011	11.11	2.55	0.80
FY2010	4.65	2.23	3.91
FY2009	0.00	3.46	5.97
5yr Avg	5.80	3.25	3.27
3yr Avg	8.22	3.51	2.15

Revenues over the past five years are growing modestly at 3.27% and over the last three years at even lower 2.15% (**Table 1**). Importantly, actual net earnings are decreasing consistently over last three years (**Exhibit 1**). Financial management in SDM appears to aggressively defend the stock price and dividends yields by buying back stocks. About 17 million shares, or 8% of maximum share volume were canceled from 2010 to 2013 (**Figure 3**). Offsetting the decline in earnings (decrease growth) with the decrease in shares (increase in earnings per share) could be gauged from the year over year growth in earning per share (EPS) averaging at 3.2% (**Table 1**). Therefore, the best case scenario for growth in SDM can be observed in the dividend growth rate of 8.2%. However, a consistent decline in earnings over the past three years suggest a more realistic growth rate for SDM to be 2%, in accordance with the growth in revenues. Negative growth rate will make predictions based on the Gordon Model less reliable. Financial management is mitigating the effects of declining revenues by a massive stock buyback that can peg effective growth for remaining shareholders at about 3.5% in the near future, but the long term sustainability of this rate if earnings continue to decline is questionable.

Figure 3: SDM share price and volume (2001-2013).



The Discount Rate for SDM

Method 1 – Published Rate

There were three possible options to determine an accurate discount rate (R) for Shoppers Drug Mart. The first, and most straightforward, was to use the discount rate that SDM published in its most recent (and final) consolidate financial statements. This risk-adjusted rate was **9%**, however no information was available on the methodology that SDM used to make those adjustments (Shoppers Drug Mart B, 2014). Accordingly, we could not evaluate the validity of this number however felt it was important to consider when trying to determine an accurate discount rate for SDM.

Method 2 – Weighted Average Cost of Capital

The second method—determining the weighted average cost of capital for Shoppers Drug Mart—required more research and several assumptions, especially regarding the value of SDM bonds in 2013.

As seen in **Table 2**, the model we used to determine SDM's cost of equity employed a combination of DGM and Security Market Line (Capital Asset Pricing Model). Inputs for DGM were retrieved from the Weston Mosaic information provided for this project, while the SML approach required further research. In order to determine the appropriate risk-free rate, we chose to use the historical interest rates on Canadian government five-year bonds (1.95%) as of December 31, 2013—the effective date of the information contained in the Weston Mosaic (Bank of Canada, n.d.). The risk coefficient (beta) for SDM is estimated at 0.64, and was retrieved from a Globe and Mail Investor report from 2013 which outlined a number of Canadian

Table 2: Calculating cost of equity for SDM

SDM Cost of Equity	
Dividend Growth Model	
Dividend Just Paid	$ 1.14
Growth Rate	5.80%
Price per share	$ 57.86
Expected Dividend	**$1.21**
Cost of Equity	**7.77%**
Security Market Line Approach (CAPM)	
Risk-Free Return	1.95%
Beta	0.64
Market Return	10.33%
Market Risk Premium	**8.38%**
Cost of Equity	**7.31%**
COST OF EQUITY	**7.54%**

stocks and their respective betas (Bowman, 2013). To calculate the market return, the gains in the TSX Composite Index covering the entire year of 2013 were used (Google Finance, n.d.). Both methods (DGM and SML/CAPM) yielded similar results of 7.77% and 7.31%, respectively, boosting our confidence to average the results to achieve a 7.54% cost of equity for SDM.

To determine the cost of debt for SDM, we researched historical bond information for SDM and made several key assumptions. From the 2013 Consolidated Financial Statement, we determined that the company had a mix of commercial debt that had been issued at various times (Shoppers Drug Mart B, 2014). All long-term debt was issued in the form of 5-Year bonds and averaged to approximately 5% annual interest (Shoppers Drug Mart B, 2014). Since the market value of Shoppers Drug Mart bonds in December of 2013 was not available, we instead used the market value of Loblaws 5-Year corporate bonds as a proxy. Since Loblaws would be assuming all of SDM's debt upon acquisition, we believed it was reasonable to assume that the bond market had adjusted expectations regarding SDM debt to align it with Loblaws, to whom the obligation would soon belong and had promised rapid repayment of existing debt (Marotte, 2013). The marginal corporate tax rate in 2013 was 38%, which was included in the model (Canada Revenue Agency, n.d.). The after tax estimated cost of debt for SDM is thus **3.1%** (**Table 3**). The remainder of the information used to calculate the appropriate E/V (0.94) and D_m/V (0.06) was collected from the 2013 Consolidated Financial Statement (Shoppers Drug Mart B, 2014). Once all of the appropriate data and assumptions were included in the model, the Weighted Average Cost of Capital for Shoppers Drug Mart was determined to be **7.27%.**

Table 3: Calculating cost of debt for SDM

SDM Cost of Debt	
Face Value	1000.00
Annual Coupon Rate	5.00%
Years to Maturity	5
Payment Frequency	2
Value of Bond	1000.00
6-Month Interest Rate	**2.50%**
Yearly Interest Rate	**5.00%**
Tax Rate	38.00%
After-Tax Cost of Debt	**3.10%**

Method 3 – Dividend Growth Model Analysis

The third method of determining an appropriate discount rate for Shoppers Drug Mart involves analyzing the data in the DGM and isolating R based on historical dividend growth

(Gordon, 1956). This relies on a key assumption: "R" in this context represents the aggregated required return from all investors on SDM stocks. Since a stock price is the direct reflection of what investors are willing to pay for it, it follows that each investor who purchases the stock is doing so because that is the price they are willing to pay for the return they expect. Therefore, isolating R based on historical dividend growth gives us the average required return on Shoppers Drug Mart stock—an excellent approximation of R to include in our model. **Table 1** summarizes the analysis of historical dividend growth rates, which led us to a geometric growth rate of **5.8%**.

This resulted in the equation seen in **Figure 4**, derived from the Gordon Model of dividend growth. We were thus able to solve for R, the historical average required return on Shoppers Drug Mart stock, which gave us a discount rate of **7.88%.**

The required rate of return (R) for SDM

Utilizing the reported rate of 9% and our calculated rates of 7.88% and 7.22%, we averaged them out to a combined discount rate of **8.05%**. Scenarios of DGM valuation of SDM stock could include discount rates in the range of 7.22% to 9%.

Figure 4: Discount Rate (Gordon Model)

$$R = \frac{D_1}{P_0} + g$$

where:

D_1 = \$1.21 (from the previous WACC analysis)
P_0 = \$57.86 (share price on date of transaction)
g = 5.8%

Predictions of future dividends and stock prices for SDM

To evaluate the potential revenues for SDM shareholders the DGM was used to calculate present value of dividends and future increases in stock prices. We considered a three year horizon to 2015—in principle longer horizons of investment can be investigated—with an increased risk for changes in R and g. Assuming that dividends will continue to grow in the future at the same rate of **5.8%** as determined through the Dividend Growth Model in the previous sections, we forecasted SDM dividends from 2013 through to 2017 (**Table 4**).

By applying these values to the dividend growth model, we were able to determine the potential stock price of SDM from 2013 to 2017, which is summarized in **Table 4**. According to the Dividend Growth Model, SDM stock would have been worth **$60** in 2015—a full $1.54 lower than what shareholders received from Loblaws in 2013. Adjusted for inflation, the $61.54 offer in 2013 is worth $62.89 in 2015, making the present value of the gain $2.89 per share. This will be a good compensation for the lost dividends from 2013 to 2015, when discounted to the present in 2013 at 8% rate to give a present value dividend yield of $3.11. While the Loblaw offer may seem 20 cents lower than our forecasted gains per share, it should be accepted by SDM investors due to the high risk embedded in the alternative worst case scenarios as depicted in **Table 5**.

Table 4: Share Price and Dividend Projections, 2013-2017

2013	P_0	**$57.86**	D_0	**$1.14**
2014	P_1	**$56.71**	D_1	**$1.21**
2015	P_2	**$60.00**	D_2	**$1.28**
2016	P_3	**$63.48**	D_3	**$1.35**
2017	P_4	**$67.17**	D_4	**$1.43**

Scenarios

We performed scenario analysis to identify potential dividends and stock prices for SDM (**Table 5**). We determine the effects of changing both growth and discount rates on the projected SDM share price and cumulative dividends to 2015. Four scenarios were compared--a “worst case” scenario in which growth rate plummeted to 5.89% and discount rate of 7.2% for SDM investors, who see the share price plummet in the absence of the Loblaws offer; an intermediate scenario, where the share price in 2015 reaches the price-per-share Loblaws offered; the potential value derived from our research and validated by our model; and a “best-case” scenario, where Shoppers Drug Mart stock price sees rapid growth from 2013 to 2015. These scenarios were selected to conform with a limited range of possibilities in accordance to the current (2013) market value of the stock of $57.86 in order to present a realistic assessment of different potential growth and discount rate that illustrated positive and negative scenarios for SDM shareholders.

Table 5: Growth/Discount Rate Scenarios

SCENARIO	Worst	Intermediate	Actual	Best
R	7.20%	7.47%	8.05%	9.00%
g	4.89%	5.31%	5.80%	6.90%
2015 Price	$ 56.85	$ 61.54	$ 60.00	$ 66.32
2015 Cumulative Dividend	$ 3.59	$ 3.60	$ 3.62	$ 3.66

It becomes apparent that the Loblaws offer of $61.54 per share is very reasonable and generous, given the projected values of SDM shares under the four separate scenarios. As previously discussed, dividend growth outpaced actual growth in revenues for a number of years. Generous dividends had inflated the value of the stock and masked the fundamental decline of the SDM business model.

Recommendation: Accept the Loblaw offer

Our financial analysis of SDM reveals a large discrepancy between the rate of dividends growth and the rate of revenue and earnings growth in the company. Notably, net earnings are slightly declining over the last three years, despite a modest increase in revenues. SDM management were able to maintain the stock price and high dividend rate by drastically reducing capital investment and through deployment of an aggressive buyback policy that eliminated almost 8% of company shares in three years. This analysis leads us to doubt the potential economic growth of the company and the sustainability of maintaining a high dividend growth for SDM over the long term in current conditions. In light of this information, the Loblaw evaluation of the SDM stock at $61.54 corresponds with our optimistic scenarios of dividend growth and discount rates. Shoppers Drug Mart shareholders were right to accept this offer in 2013, since there is a considerable risk that the SDM stock was overvalued by the financial markets and could experience a downwards correction in subsequent years.

References

Bank of Canada. (n.d.). Canadian Bond Yields: 10-Year Lookup. [Accessed: March 27, 2015]. Retrieved from http://www.bankofcanada.ca/rates/interest-rates/lookup-bond-yields/

Bowman, M. (2013, April 23). 19 Resilient Canadian Stocks for Volatile Times. *The Globe and Mail*. Retrieved from http://www.theglobeandmail.com/globe-investor/investment-ideas/number-cruncher/19-resilient-canadian-stocks-for-volatile-times/article11511184/

Canada Revenue Agency. (n.d.). Corporation tax rates. Retrieved from http://www.cra-arc.gc.ca/tx/bsnss/tpcs/crprtns/rts-eng.html

Google Finance. (n.d.). S&P/TSX Composite Index. [Accessed: March 27, 2013]. Retrieved from http://www.theglobeandmail.com/globe-investor/investment-ideas/number-cruncher/19-resilient-canadian-stocks-for-volatile-times/article11511184/

Gordon, M. J., & Shapiro, E. (1956). Capital equipment analysis: the required rate of profit. *Management science*, *3*(1), 102-110.

Marotte, B. (2013, July 13). Loblaws to buy Shoppers Drug Mart for 12.4B. *Business News Network*. Retrieved from http://www.bnn.ca/News/2013/7/15/Loblaw-to-buy-Shoppers-Drug-Mart-for-124B.aspx

Shaw, H. (2012). Shoppers Drug Mart hikes dividend. *Financial Post*. February 9, 2012.

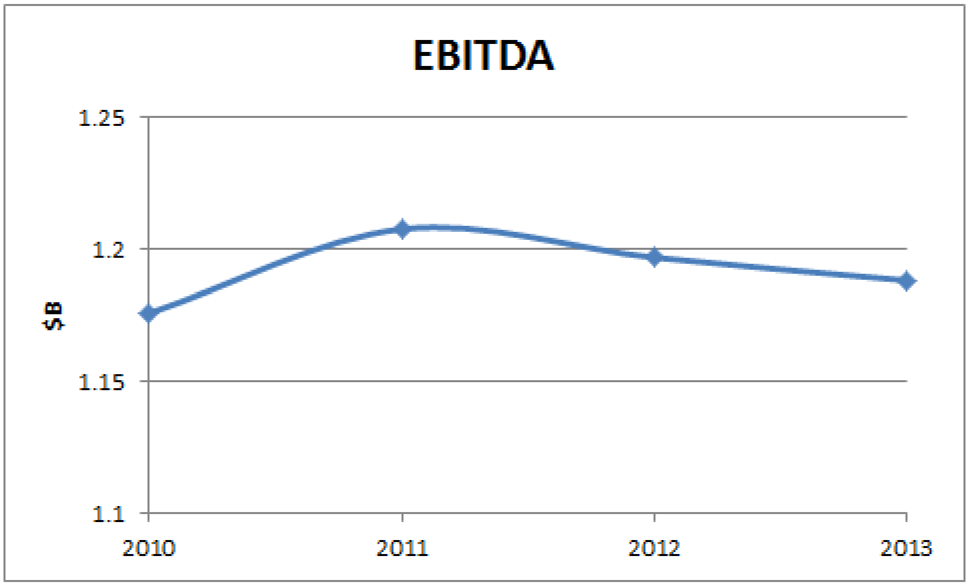
Shoppers Drug Mart. (n.d.). Our Company. Retrieved from http://corporate.shoppersdrugmart.ca/en-ca/about-us/our-company

Shoppers Drug Mart A. (2014, February 6). Shoppers Drug Mart Corporation reports strong fourth quarter results [Press Release]. Retrieved from http://www.newswire.ca/en/story/1301235/shoppers-drug-mart-corporation-reports-strong-fourth-quarter-results

Shoppers Drug Mart B. (2014, February 20). *Annual Consolidated Financial Statement*. Retrieved from: http://corporate.shoppersdrugmart.ca/en-ca/about-us/financial-information/annual---quarterly-reports

Exhibits

Exhibit 1: Average EBITDA growth is modest at 0.36% and the trend is declining



Earnings before income tax depreciation added for SDM (2010-2013).
(Source: Bloomberg Terminal)