The Writing on the Wall – Part 2

Perspectives: July 23rd, 2024

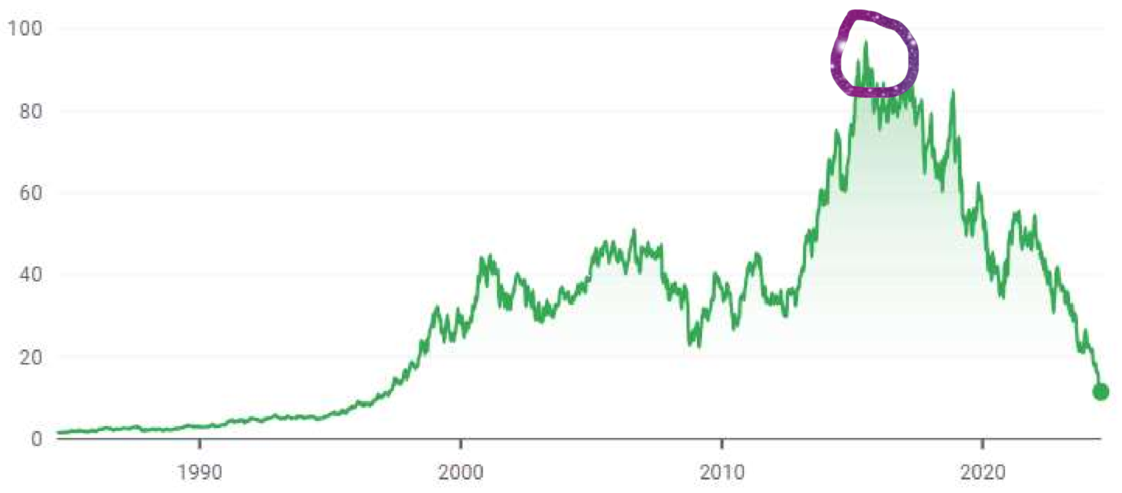
"Have you seen the writing on the wall?
Have you seen that writing?
Can you see the riders on the storm?
Can you see them riding? Can you see them riding ?"

Source: Iron Maiden – The Writing on the Wall

One of the more interesting puzzles on the South African stock market is the persistent sky-high valuation multiples of pharmacy retailers Clicks and Dischem. Of the two, Clicks is by a long way the better business, but they both currently trade on a trailing price to earnings multiple of 31. This high valuation multiple implies that the market consensus expects continued high growth. As companies largely focused on doing business in South Africa, their high valuation multiples are completely out of sync with the low valuation multiples of listed 'SA Inc' companies in other local industries.

Over here on the ground in North America, the long-term share price chart of US listed pharmacy retailer Walgreen Boots Alliance paints a *quite different* picture...

Chart: Walgreen Boots Alliance Share Price 1984 - 2024



Source: Google Finance

In mid 2015, indicated by the circle in the chart, Walgreens was priced by the market at a high price to earnings multiple of 40. *For context, please bear in mind the long-term average price to earnings multiple of the high quality and high growth S&P500 index is about 15 times. This means that by pricing a stock at 40 times the market consensus is expecting serious fireworks in the future.* From that peak point to now, the share price has already declined by a scary 88%. To make matters worse, the business is today significantly loss-making, together with a highly geared balance sheet, and is also grappling with higher interest rates and lower discretionary consumer spending. This company is in real trouble.

There was no clear warning signs in the historical financials between 1984 and 2015 to even suggest troublesome times ahead, let alone the disaster that has unfolded. Viewed in 2015, this looked like a high quality long-term growth business, which is consistently profitable, and delivers predictable, stable free cash flows and dividends.

So, what really happened to Walgreens? Three key events, in sequence.

Firstly, they started experiencing credible new competition in pharmacy retail from seriously smart, well funded, large-scale, and ultra efficiently low-cost industry entrants such as Walmart, Costco, and Amazon.

Secondly, they responded as challenged companies often do – by trying to *grow* their way out of trouble by acquisition. Not only did they buy another business, but they did a transformatively large sized deal to acquire a company in another country, continent, time zone, and that operates with a different business culture.

Thirdly, they funded said acquisition by piling a high level of debt onto their balance sheet.

Now - circling back to our two South African listed pharmacy retailers, Clicks and Dischem.

Their share prices, high valuation multiples, and historical financial results all indicate that the market consensus is to think highly of them and their continued growth prospects.

However, people on the ground in South Africa will also know that credible new competition in the pharmacy retail industry has developed already, or is in the process of developing, from the likes of Shoprite (*branded as Medirite*), Spar, Pick 'n Pay, Woolworths (*in partnership with Netcare*), Walmart (*that entered South Africa by acquiring Massmart*), and Amazon (*who had invested in and recently completed a state of the art R4,5bn multi-purpose head office complex in Cape Town*).

It now remains to be seen how well Clicks and Dischem respond to compete with this host of relative newcomers to their industry. To date we have not seen large-scale acquisitions, outside South Africa, funded with debt, by either company.

Our work continues...

Daniel Malan, CFA
Founder, Managing Director & Chief Investment Officer
daniel@perspectiveim.co.za

Perspective Investment Management
www.perspectiveim.co.za
