Is Jean Coutu Group PJC Inc. a Buy on Strong Earnings Results?

Description

Canadian pharmacy franchise chain **Jean Coutu PJC Inc.** (TSX:PJC.A) beat analyst earnings estimates on Wednesday, reporting earnings of $0.27 per share, which was $0.02 higher than the consensus analyst estimate of $0.25 per share, boosting the retailer's share price by approximately 2% on the day.

The profitability increase was linked to improved royalty rates on franchise sales of 0.4%; the increased royalty rates have generally been expected to remain the same over time, with analysts pointing to the fact that improving same-store sales and revenue justify the increase. The increase in royalty rates is also aligned with an increase in professional allowances from generic drug manufacturers and a one-time adjustment from the provincial government relating to prior dispensing revenue, both of which were factors leading to the better-than-expected results this week.

With the Canadian pharmacy business generally outperforming other brick-and-mortar retail operations, such as grocery retail, due to higher margins and sales-per-square foot, long-term investors looking for retail exposure have long considered pharmacies as an excellent growth business.

Jean Coutu remains a unique pharmacy retailer for two main reasons. First, its operations are focused in Quebec, meaning it is uniquely exposed to the political and economic environment of the province. Second, the company is a franchise operation relying on royalty revenue, which is different from other corporate-owned models or hybrid models which are common among other pharmacy chains.

With Jean Coutu's franchise/royalty model underpinning its growth strategy in eastern Canada, investors must weigh the unique risks associated with investing in a company that is not as geographically diversified as other retailers. That said, should the Quebec economy improve more rapidly than the rest of the country, investors are likely to experience a much larger windfall.

One of the largest tailwinds for Jean Coutu of late has been discussions about how marijuana will be dispensed in Quebec once the drug is legalized. With expectations that pharmacies may be at the front of the line in receiving retail licences for cannabis, investors will be paying close attention to how legalization will roll out and how the licensing program will affect companies like Jean Coutu. Investors bullish on pharmacies' ability to leverage the "green rush" in Canada have highlighted this possibility as one of the main investment theses to look at Jean Coutu.

In terms of tailwinds, Jean Coutu remains at the wrong end of a pricing dispute between the minister of health of Quebec and the generic drug industry, as generic drug pricing coinciding with a cap on professional allowances (expected to come in at 15%) which is likely to hamper profitability moving forward. While the cap on professional allowances and expected lower drug prices are not expected to take place until the end of next year, investors have begun to price these headwinds in to Jean Coutu's stock price; with a drop of nearly 13% since the end of April, this pullback may be a great opportunity for investors looking at the pharmacy business to get in.

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