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<b>New Rec: Jean Coutu</b>	<b>(PJC/SV/ACN: C\$19.50*)</b>	<b>Oct. 6, 2005</b>
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\*Bloomberg symbol. Trades on the Toronto Stock Exchange:TSX

**Position: Sell**

**Target: C\$14**

<b>\$000 (US)</b>	<b>FQ1 06E</b>	<b>FQ2 06E</b>	<b>FQ3 06E</b>	<b>FQ4 06E</b>	<b>F2006E</b>	<b>F2007E</b>
<b>Revs</b>	<b>2,713,640</b>	<b>2,710,547</b>	<b>2,846,947</b>	<b>2,809,339</b>	<b>11,080,472</b>	<b>11,524,098</b>
<b>EPS \$</b>	<b>0.10</b>	<b>0.10</b>	<b>0.23</b>	<b>0.19</b>	<b>0.62</b>	<b>0.95</b>
<b>Y/Y Gr</b>	<b>10%</b>	<b>n/a</b>	<b>49%</b>	<b>5%</b>	<b>51%</b>	<b>54%</b>
<b>PE</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>26.7</b>	<b>17.4</b>
<b>PSR</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>0.39</b>	<b>0.38</b>
<b>Consens</b>	<b>0.15</b>	<b>0.19</b>	<b>0.23</b>	<b>0.25</b>	<b>0.80</b>	<b>1.01</b>

**Shares Out: 262M**

**Market Cap: \$4.3B**

**FYE: May**

Summary: The Jean Coutu Group (PJC) is one of North America's largest drug retailers. PJC is the second largest drugstore chain in Canada with 321 franchised stores as of May 28, 2005, and is the dominant drug retailer in Quebec, where it

has 294 outlets. In the US, PJC's Brooks and Eckerd stores comprise the fourth largest chain in the US, after CVS, Walgreens and Rite-Aid, and the second largest in the eastern US (after CVS). At FY 05 year-end, PJC had 1,922 US stores, consisting of 335 Brooks stores and 1,587 Eckerd stores.

Brooks is primarily a New England chain with half of its stores in Massachusetts. Other key states for Brooks are Rhode Island, New Hampshire and Vermont. In April 2004, PJC bought 1,549 Eckerd stores, mostly on the eastern seaboard from Connecticut to Georgia, from J. C. Penney for \$2.5B. The transaction was completed in July 2004, which was FQ1 05 for PJC. After the Eckerd acquisition, states with a major PJC presence include New York (370 stores), Pennsylvania (300 stores) and North Carolina (260 stores). Since a majority of PJC's post-acquisition total revenues result from US operations, PJC changed its reporting currency from the Canadian dollar to the US dollar at the beginning of FY 05.

PJC shares are up 14% YTD on optimism that the integration is almost complete, and that synergies should start to flow through to the bottom line in FY 06. The bulls have derived enthusiasm from various tidbits of information provided by management on the FQ4 05 conference call in August and at the company's annual meeting in September with respect to Eckerd's recent performance. These positive hints dropped by management pertain to same-store sales performance at beauty and personal care, OTC drugs, improvement in shrink, generic substitution and private label penetration.

We think that by focusing on isolated pieces of data, which we discuss in detail in the discussion section, PJC bulls may be missing the big picture. The big picture is that in an era where convenience is paramount, Brooks and Eckerd do not appear to have a very competitive offering. One piece of evidence that supports this is that Brooks, whose performance metrics are cited as goals for Eckerd to achieve, itself has badly underperformed CVS and Walgreens in comps in recent quarters in both front store and in Rx. We are therefore puzzled as to why bulls cheer management when it announces that Eckerd is a bit closer to Brooks each quarter.

To consider where Brooks and Eckerd have fallen short, consider freestanding units. Pioneered by Walgreens in the mid-nineties, this format, which features ample parking and frequently a drive-through prescription pick-up window, is the paradigm of convenience for this business. Over 80% of Walgreens stores today are freestanding units. While CVS was slow to recognize the benefit, the company has aggressively pursued this format in recent years, spending more than a billion dollars annually since 2002. 58% of CVS stores now are freestanding units, up from a third five years ago. At Eckerd and Brooks, on the other hand, the

current proportions of total stores with freestanding units are 55% and 40%, respectively. Similarly, while a third of Walgreens stores (and 12% of CVS stores) have 24-hour service, at Brooks and Eckerd it is just 2%.

What is an even bigger problem for PJC is that it does not have the financial wherewithal to rectify this competitive imbalance. The large amount of debt required to fund the acquisition has restrictive covenants with respect to capital expenditures. As a result, PJC can spend just 2% of revenues (or \$225M) on store openings, relocations and improvements, while CVS and Walgreens are spending on the order of \$1.4B to open, relocate and remodel stores, especially in Eckerd's primary states such as North Carolina, Georgia, South Carolina and Pennsylvania.

PJC's US operations face other competitive hurdles as well. First, PJC procures close to 90% of its branded drugs from McKesson whereas CVS and Walgreens have enough heft to order directly from drug manufacturers at lower cost. Second, PJC lacks a pharmacy benefits manager (PBM) unlike its larger rivals and is therefore more exposed to the threat of mandatory Rx mail orders. To date, mandatory Rx mail ordering has been a Midwest phenomenon led by the Big Three auto makers and the UAW, but it may only be a matter of time before cost concerns compel other employers to adopt it.

As a result of these issues, we anticipate that PJC will fall short of "street" estimates on revenue and EBITDA. We expect that PJC will post \$11.1B and \$11.5B of revenues in FY 06 and FY 07, respectively, compared to "street" estimates of \$11.4B and \$12.0B. Similarly, we expect EBITDA to fall short of "street" estimates of \$655M in FY 06 and \$753M in FY 07 by \$56M and \$31M, respectively. We use EBITDA instead of EPS for two reasons. First, as a result of the debt financed acquisition, tax rates have come down significantly from FY 04's 31.5% rate. The tax rate in FY 05 was -13.7%. Therefore, comparisons based on EPS are not meaningful. Second, using EBITDA permits us to compare valuations of PJC with competitors on an operational basis, without taking capital structure into account.

Despite the competitive issues we cited, at 10.5X next twelve month EBITDA PJC trades at a premium to all of its competitors other than Walgreens. As we show in the valuation section, this type of premium valuation is not because investors expect superior EBITDA margins or because there is low balance sheet risk. Rather, the company most like PJC is Rite Aid, which trades at 7X NTM EBITDA. Using CVS's multiple of 9X, which we think is quite generous given that company's market presence and financial strength, gets us to a share valuation of C\$13.67 for PJC, 30% below today's close. Our initial price target is \$14.

The new Medicare Rx plan could be a positive for JPC, as it would be for other pharmacy chains. However, the plan is complicated, with a donut between \$2,250 and \$5,100 when the patient bears all drug expenditures. Therefore, it may be some time before significant numbers of users sign up and the expected higher drug usage results. Moreover, the plan is likely to lead to heavier use of generic drugs, which have lower prices and therefore a negative top line impact. Generics do provide drugstores with higher gross margins, but the usage levels at which the overall impact to the bottom line is positive remains unclear at this time.

Jean Coutu shares are held mainly by Canadian investors, and analyst coverage is provided by American firms with analysts in Canada. Jean Coutu files with the SEC since last year. The shares trade on the Toronto Stock Exchange.

#### Background:

The Jean Coutu Group (PJC) is one of North America's largest drug retailers. Founded in 1969 and headquartered in Longueuil, Quebec, Canada, the company is the second largest drugstore chain in Canada with 321 franchised stores as of May 28, 2005, and is the dominant drug retailer in Quebec, where it has 294 outlets. In the US, PJC's Brooks and Eckerd stores comprise the fourth largest chain in the US, after CVS, Walgreens and Rite-Aid, and the second largest in the eastern US (after CVS). At fiscal year-end, PJC had 1,922 US stores, consisting of 335 Brooks stores and 1,587 Eckerd stores. Table 1 lists the largest drugstore chains in North America.

Table 1: Largest North American drugstore companies

Company	Store count
CVS	5,400
Walgreens	5,000
Rite Aid	3,350
PJC	2,200
Medicine Shoppe	1,250
Shoppers Drug Mart	927
Osco/Sav-On	700
Longs Drug Stores	475
Duane Reed	255

Source: Company reports

In Canada, only pharmacists are allowed to own pharmacies. Therefore, PJC relies on a franchise model, wherein it provides pharmacy and front-end merchandise to franchisees from its distribution center, as well as support services such as loss prevention, HR and IT. PJC receives about 4% in royalties from franchisee sales and fees for support services it renders. The company also makes a profit on the merchandise it distributes. In addition to its Quebec stores, PJC also

has 18 stores in New Brunswick and 9 in Ontario. The number of PJC franchised stores has stayed relatively constant in the past five years (Table 2). In FY 06, PJC plans to open 7 stores and relocate 15 other stores.

Table 2: PJC franchised store count in Canada

	FY 01	FY 02	FY 03	FY 04	FY 05
Store count at beginning of period	291	293	302	311	319
Stores added	3	5	3	4	-
New stores (no Rx purchase or transfer)	2	11	8	5	2
Stores closed or sold	3	7	2	1	-
Store count at end of period	293	302	311	319	321

Source: Company reports

In the US, PJC owns Brooks and Eckerd stores. In April 2004, J.C. Penney announced the sale of its 2,800 Eckerd stores to CVS and PJC. CVS purchased Eckerd's pharmacy benefits management (PBM) business and 1,260 stores, primarily in Florida and Texas. PJC bought 1,549 Eckerd stores, mostly on the eastern seaboard from Connecticut to Georgia, for \$2.5B, a transaction that was completed in July 2004. After the transaction, states with a major PJC presence include New York (370 stores), Pennsylvania (300 stores) and North Carolina (260 stores). A complete store count by state as of May 28, 2005 is shown in Table 3. Since a majority of PJC's post-acquisition total revenues result from US operations, PJC changed its reporting currency from the Canadian dollar to the US dollar at the beginning of FY 05.

Table 3: PJC store count by state in the US at FY 05 end

State	Number of Brooks pharmacy stores	Number of Eckerd pharmacy stores
Connecticut	47	7
Delaware	-	22
Georgia	-	211
Maryland	-	25
Maine	6	-
Massachusetts	165	-
New Hampshire	38	-
New Jersey	-	147
New York	2	368
North Carolina	-	259
Ohio	-	1
Pennsylvania	-	297
Rhode Island	46	-
South Carolina	-	111
Tennessee	-	50
Virginia	-	87
Vermont	31	-
West Virginia	-	2
Total	335	1,587

Source: Company reports

Brooks and Eckerd stores each have about 11,000 square feet of gross space, and 8,500 square feet of selling space. This is comparable to the average CVS store square footage, but is smaller than the average Walgreens store, which has gross area of 14,500 square feet and selling space of 11,000 square feet.

PJC purchases its branded drugs from wholesaler McKesson Corporation. In FY 05, 87% of the dollar volume of branded prescription drugs was purchased from McKesson. The company had six distribution centers at fiscal year-end supporting its 1,900 US stores. CVS and Walgreens have 13 and 14 distribution centers, respectively. Because of their large warehouse capacities, these two largest US chains get their branded drug supplies directly from suppliers, resulting in lower drug costs.

#### Discussion:

1. PJC shares are up 14% YTD, exceeding the YTD performances of both the S&P/TSX drug retail index at +10.3% and the S&P/TSX Food & Staples retailer index at +7.1%. This handsome appreciation in the share price is due to the “street’s” belief, based on selective data released by management on recent conference calls, that PJC is making good progress at integrating Eckerd. Therefore, the “street” expects that significantly improved sales and EBITDA should ensue in FY 06 for PJC as a result of positive comps and higher gross margins for the Eckerd segment.

Eckerd’s recent performance has been poor, so we do anticipate some improvement in comps and profitability. Based on our research, however, we differ over the magnitude of the improvements expected by the “street”. Moreover, as we discuss further below, PJC’s stretched balance sheet should make it harder for Brooks and Eckerd to compete effectively with Walgreens and CVS, which are opening stores at a rapid clip in Eckerd’s backyard.

2. Bulls have taken comfort in pieces of information disclosed by management related to the Eckerd integration and project significant improvements in sales and EBITDA for PJC based on the limited data. We think it is a mistake to draw such optimistic inferences from the disclosed data.

While PJC management has been reticent to provide estimates for synergy, on its latest conference call and at the annual meeting, management did offer a few tidbits pertaining to improvements at Eckerd since PJC’s acquisition. Table 4 lists some of these improvements. We note that since no information is available for the same metrics in the prior four quarters, it is difficult to determine whether these trends represent rebound from a trough or are signs of meaningful improvements.

Table 4: Eckerd improvement data points from PJC management

	FQ1 05	FQ2 05	FQ3 05	FQ4 05
Beauty & personal care comps	-9.0%	-5.0%	-3.5%	-0.7%
OTC comps	-4.0%	-1.1%	-0.4%	3.2%

Source: Company reports

In addition, management said on the FQ4 call that Rx comps had turned positive in FQ1 06, after being “decimal point negative” in FQ4 05. Furthermore, according to management, front end shrink had improved by 70 to 90 basis points based on PJC’s latest inventory survey, and conceivably by even more because of differences in shrink measurement between previous management and PJC. In PJC’s annual meeting, held a couple of weeks ago, the CEO said that shrink was down to 3.2% versus 5% when the chain was acquired, or an improvement of 180 basis points.

Despite these positive data points related to Eckerd comps and shrink, US gross margin, adjusting for changes in benefits estimates, was essentially flat at 25% in the last three quarters of FY 05. This suggests to us that the data points made available by management are interesting, but not particularly useful for projecting future performance, as many “street” analysts have done, because the improvements in shrink and in other areas have been offset by other costs. “Street” analysts appear to be projecting further improvements in some cost areas, while ignoring that the offsets to those improvements are also likely to continue. It is also likely that further improvements in shrink may prove harder to come by.

3. Industry experts suggest that the best drugstore configurations combine freestanding units with drive-through capability. Walgreens pioneered this format in the early nineties, and achieved 30% sales increases “right out of the box” compared to inline (or grocery-store anchored strip center units). As Table 5 shows, Brooks and Eckerd lag in this regard. According to industry sources, besides out-of-stock issues and hours, the large proportion of inline stores is a leading cause of Eckerd’s historical underperformance.

Table 5: Freestanding and drive-through store data for US drugstore chains

	% of total stores that are freestanding	% of total stores with drive-through counters
Walgreens	82%	81%
CVS	58%	40%
Rite Aid	54%	39%
Eckerd	55%	49%
Brooks	40%	26%

Sources: Company reports, industry sources

Moreover, we note that CVS and Walgreens plan to spend \$1.4B each in the next year to open or relocate 300 and 400 net stores, respectively. These store related expenditures represent 3.8% of sales for CVS and 3.0% of sales for Walgreens. By contrast, as a result of limits placed by covenants related to debt resulting from the Eckerd acquisition, PJC plans to spend just \$225M (or 2% of sales) to open or relocate 57 stores. Even Rite Aid, which is heavily indebted like PJC, plans to spend a higher portion of revenues (2.2%) than PJC on store openings, relocation and remodeling in FY 06.

Meanwhile, out of CVS's 64 new store openings since the beginning of the year, 11 have been in Eckerd's top six states. In the case of Walgreens, of the 371 net new stores opened in FY 05, 67 have been in Eckerd's top six states. North Carolina and Georgia, in particular, are being targeted by both of these chains. PJC, on the other hand, has indicated that it will close 78 underperforming Eckerd stores in FQ1 06. Thus, net store count in the US is expected to decline by 20 in FY 06, which makes for a less competitive presence in its markets. The bulls ignore this dynamic, which we think is likely to be detrimental to Eckerd's (and Brooks') sales and gross margin performances.

4. PJC management aims to bring Eckerd stores to Brooks' level in private label penetration, beauty and health sales, and shrink, conveying the impression that Brooks is an unmitigated success story. However, besides lagging peers in convenience as Table 5 above showed, Brooks' comps are also mediocre relative to the competition (Table 6).

Table 6: Brooks' comps versus peers

	2005 March/May quarter	2005 June/August quarter
Brooks front store	2.2%	1.6%
Brooks Rx	4.0%	3.8%
Brooks Total	3.4%	3.1%
CVS front store	6.9%	1.7%
CVS Rx	8.8%	7.4%
CVS Total	8.2%	5.6%
Walgreens front store	6.1%	5.8%
Walgreens Rx	10.2%	7.7%
Walgreens Total	8.7%	7.0%

Source: Company reports

Thus, even getting Eckerd to Brooks' level would lead to significant underperformance vis-à-vis peers, a problem that will be compounded by stingy spending on new stores and store improvements. We think that this could result in an "Eckerd déjà vu" scenario for PJC's US segment.

5. As we indicated earlier, PJC's acquisition of Eckerd stores levered up the balance sheet significantly. The company paid \$2.5B to purchase the Eckerd assets, and funded this amount from three sources: issuance of \$1.35B of variable-rate secured debt, \$1.2B of unsecured, issuance of fixed-rate, medium-term senior notes with a weighted average rate of 8.25%, and issuance of \$424M of Class A subordinate voting shares (33.4M shares).

As a result of these issuances, total debt to book equity was 181% at FY 05 year-end, compared to 25% at FY 04 year-end. Not only has this made PJC's balance sheet much riskier, covenants related to the senior secured credit facility also restrict the company's ability to make capital expenditures exceeding about \$230M (or 2% of sales). While management appeared to suggest that this limitation was no big deal on the latest conference call, this restriction places the company's US operations, which are already laggards on convenience, at a substantial disadvantage with respect to CVS and Walgreens, as we pointed out earlier.

Earlier this week, S&P downgraded PJC's debt rating by one level to B+ from BB-. The ratings agency said that sales have not risen as fast as expected and that PJC has not yet benefited from cost cuts related to store closures and consolidation of distribution operations. S&P also said that the primary issue behind the downgrade was not margin improvement, which the agency felt was likely to happen, but revenue growth, which was slower than S&P anticipated. While S&P's comments pertain to the last three quarters, we think that revenue disappointments will continue as a result of Brooks' and Eckerd's weak market positions and PJC's inability to address the weakness through competitive levels of capital spending.

6. PJC reported FQ4 05 results on August 3<sup>rd</sup>. Revenue, EPS, EBITDA and EBITDA margin all missed expectations. EBITDA, in particular, underperformed the expectations of some "street" analysts by as much as 15%. The primary reasons for the misses were weak comps at Brooks and weak Canadian Rx comps. PJC also attempted to explain some of the earnings miss by emphasizing that it had run dual Eckerd infrastructures (the old Tampa facility and Brooks' Warwick, RI facility) from the time of the acquisition (July 2004) through the end of FY 05, but investors were especially disappointed that CVS, which reported the same day, appeared to be making far better progress on its Florida and Texas stores.

Free cash flow for the fiscal year was \$41.9M, down from \$113.6M in FY 04. As we discussed previously, balance sheet leverage was up substantially, with net debt totaling \$2.4B at FY 05 year-end, compared to \$193K a year earlier. Net debt to pro forma EBITDA was 4.8 at fiscal year-end. Management aims to bring this figure to 3.5 by FQ1 07.

At fiscal year-end, book value was \$5.39, while tangible book totaled –70 cents. PJC does own 166 properties in Canada, including all or parts of strip malls and commercial buildings, and 102 properties in the US, including 84 Brooks stores and the Brooks headquarters. These properties are on the books at less than \$3 per share.

## 7. Financial assumptions.

### a. Canadian revenues.

As mentioned previously, Canadian revenues consist of franchisee royalties, sales to franchises from PJC distribution centers, and compensation for ancillary services. Table 7 shows the various components of Canadian revenues for FY 05. In general, royalty and distribution revenues (in US dollars) in a period compared to the year-ago period are dependent on store growth, comps and the exchange rate change in that period versus the year-ago period.

Table 7: Canadian revenue components in FY 05

(All amounts in 000 US dollars)	FQ1 05	FQ2 05	FQ3 05	FQ4 05
Canada revenues	312,714	365,715	359,371	368,520
Y/Y growth	13.5%	15.2%	13.0%	13.5%
Canada retail sales	482,061	542,912	583,142	565,313
Y/Y change	6.9%	13.7%	13.2%	14.0%
Average stores	320	321	321	321
Y/Y change	2.6%	1.6%	0.6%	0.6%
Retail sales per store	1502	1691	1817	1761
Y/Y change	3.9%	11.9%	12.5%	13.3%
Average USD/CAD exchange rate	0.7630	0.8493	0.8060	0.7946
Y/Y change	5.7%	10.2%	8.0%	8.6%
Canada total comps	6.1%	6.1%	5.5%	4.3%
Royalty revenue estimate @4%	19,282	21,716	23,326	22,613
Distribution sales	276,057	325,265	318,883	327,948
Y/Y distribution sales	13.9%	14.8%	14.0%	14.0%
Ancillary revenue	17,375	18,733	17,162	17,959
Y/Y change	14.7%	24.3%	-1.9%	3.1%

Sources: Company reports, OWS estimates

Going forward, we assume total store comps of 5%, store growth of 7 stores in FY 06 (per company guidance) and 8 stores in FY 07, and the average exchange rate to be 0.85 US dollar per Canadian dollar (which approximates today's rate) through FY 07. For ancillary revenues, we assume future growth rates to be equal to the average of the growth rates in the prior four quarters.

b. US revenues.

Table 8 shows Brooks' comps over the past eight quarters. Total comps have declined from near 5% a couple of years ago to near 3%. We generously assume comp growth of 5% at Brooks through FY 07. For Eckerd, the last comp data we have is from the quarter ended October 25, 2003. During that quarter, Eckerd's comp was -1%, with Rx comp of +1.4% and front store comp of -6.5%. We assume that Eckerd will post positive comps starting at +1% in FQ1 06, and that comps will rise to 2.5% by the end of FY 07.

Table 8: Brooks' same store sales growth in FY 04 and FY 05

	FQ1 04	FQ2 04	FQ3 04	FQ4 04	FQ1 05	FQ2 05	FQ3 05	FQ4 05
Front end	2.6%	4.6%	1.2%	0.4%	-1.4%	0.6%	2.2%	1.6%
Rx	5.7%	4.3%	5.4%	5.6%	3.8%	4.7%	4.0%	3.8%
Total	4.7%	4.4%	4.0%	4.0%	2.2%	3.5%	3.4%	3.1%

Source: Company reports

c. Gross margin.

As shown in Table 9, Canadian gross margins on distribution sales have ranged from 8.8% to 9.9% over the past eight quarters. We assume gross margin of 9.7% in both FY 06 and FY 07.

Table 9: Gross margin trend on Canadian distributor sales

	FQ1 04	FQ2 04	FQ3 04	FQ4 04	FQ1 05	FQ2 05	FQ3 05	FQ4 05
Gross margin	9.7%	9.3%	9.6%	9.9%	8.8%	9.8%	9.4%	9.7%

Source: Company reports

In the US, adjusting for Eckerd-related accruals, gross margin has remained relatively flat over the past three quarters. This is in spite of three significant improvements at Eckerd that management has cited: at least 70 to 90 basis points of shrink improvements, an 800 basis point increase in generic drug substitution and increase in private label penetration from 7% of front-end sales at acquisition to 9% by the end of FY 05.

Table 10: US gross margin trend

	FQ1 04	FQ2 04	FQ3 04	FQ4 04	FQ1 05	FQ2 05	FQ3 05	FQ4 05
Gross margin	25.6%	24.6%	24.9%	24.8%	25.6%	25.0%*	25.1%*	25.2%*

\* Adjusting for Eckerd-related accruals

Source: Company reports

Going forward, we anticipate that gross margin will improve to 26% by the end of FY 07. Some "street" analysts have gross margin reaching nearly 28% by the end of FY 06.

d. SG&A expense.

Table 11 shows historical SG&A expenses for the past eight quarters for both Canada and the US. For Canada, we assume that SG&A as a fraction of sales will range from 9% to 9.5% over the next two fiscal years. In the case of the US, while Brooks had SG&A as a fraction of sales ranging from 18% to 20% in FY 04, we think that the marked increased geographic presence for PJC and heightened competition as Walgreens and CVS open new stores will limit the ability of PJC to lower this metric. While synergies and the disposition of Eckerd's Tampa headquarters building will help reduce SG&A dollars in the next couple of quarters, we forecast that SG&A expenses as a fraction of sales will decline only gradually to 20% by the end of FY 07. We note that this is quite generous, given that Walgreens spent 22.2% of sales on SG&A in its recently completed fiscal year (ended August 31, 2005).

Table 11: SG&A as a fraction of sales

	FQ1 04	FQ2 04	FQ3 04	FQ4 04	FQ1 05	FQ2 05	FQ3 05	FQ4 05
Canada SG&A as % of sales	9.6%	9.1%	9.6%	10.0%	9.7%	9.4%	9.7%	8.8%
US SG&A as % of sales	19.9%	18.6%	18.2%	18.3%	22.7%	21.4%	21.3%	21.3%

Source: Company reports

e. Other items.

Since the completion of the Eckerd acquisition, quarterly amortization expense has been running around \$56M-\$57M. We forecast similar levels through FY 07.

PJC reported average interest expense of 7.3% on its \$2.5B debt in FQ4 05. Given that 55% of PJC's debt is variable-rate and that interest rates are expected to rise, we forecast that average interest expense will rise to 8% by the end of FY 07. We do assume about \$300M of debt paydown from free cash over the next two years.

Management has not provided explicit guidance on tax rates for FY 06 and FY 07. However, the company has indicated that they will be lower than the FY 04 rate of 31.5%, and that the average of tax rates FY 05, FY 06 and FY 07 will approximate 20%. Given that the tax rate in FY 05 was -13.7%, we assume 13.5% in FY 06 and 20% in FY 07.

8. Valuation and risks.

Based on the assumptions laid out above, our estimates for PJC’s revenue, EPS and EBITDA are shown in Table 12, along with the corresponding “street” estimates.

Table 12: OWS and “street” estimates for PJC’s revenue, EPS and EBITDA in FY 06 & FY 07.

	OWS estimate	“Street” estimate
FY 06 revenue (\$MM)	11.1	11.4
FY 06 EPS (\$)	0.62	0.82
FY 06 EBITDA (\$MM)	599	655
FY 07 revenue (\$MM)	11.5	12.0
FY 07 EPS (\$)	0.95	1.05
FY 07 EBITDA (\$MM)	722	753

Sources: OWS estimates, “street” reports

Because of the uncertainty associated with PJC’s tax rates, many “street” analysts value the company on an EV/EBITDA basis. We think this is an appropriate metric since it permits us to compare companies on an operational basis without regard to capital structure and also removes the tax issue from consideration.

In Table 13, we use this metric to compare PJC with its US peers (since the company derives 85% of its sales from the US), using EBITDA estimates for the next four quarters. We note that PJC trades at a significant premium to CVS, despite having a leverage profile similar to Rite Aid.

Table 13: EV/EBITDA valuations of major US drugstore chains

	CVS	Walgreens	Rite Aid	PJC
Diluted shares (MM)	842	1,025	533	262
Stock price (\$)	26.30	43.98	3.75	19.38
Cash (\$MM)	414	577	90	132
ST investments (\$MM)	-	495	-	79
ST debt (\$MM)	875	-	-	-
Current portion of LT debt (\$MM)	338	-	52	66
LT debt (\$MM)	1,630	-	2,813	2,496
Net debt (\$MM)	2,429	(1,072)	2,775	2,351
EV (\$MM)	24,571	44,004	4,773	7,421
NTM EBITDA (\$MM)	2,753	3,416	680	599
EV/EBITDA	8.9	12.9	7.0	10.5
Exchange rate (CAD/USD)	1.0	1.0	1.0	0.85
Expected NTM sales (\$MM)	38,565	47,329	17,359	11,524
Expected EBITDA margin	7.1%	7.2%	3.9%	5.2%
Net debt/NTM EBITDA	0.9	(0.3)	4.1	3.9

Sources: Company reports, OWS estimates

In our opinion, given the company’s revenue and EBITDA growth prospects, a multiple similar to CVS is generous. At 9X EBITDA, we obtain a

value of \$5.4B for PJC’s EV, resulting in a share price of C\$13.67. Our initial target price is C\$14.

The primary risk to our story is that PJC meets “street” comp, revenue and EBITDA estimates in a given quarter, which would result in a short-term risk to a short position. However, as we have discussed earlier, given PJC’s weak competitive positioning, we expect Brooks and Eckerd to continue to underperform CVS and Walgreens and, as a result, to lose share.

## 9. Financial projections.

### a. Quarterly projections.

	FQ1 06E	FQ2 06E	FQ3 06E	FQ4 06E	FQ1 07E	FQ2 07E	FQ3 07E	FQ4 07E
Total revenues	2,713,640	2,710,547	2,846,947	2,809,339	2,790,330	2,828,463	2,971,287	2,934,018
COGS	2,044,726	2,039,621	2,139,214	2,109,924	2,092,999	2,121,309	2,226,539	2,198,777
SG&A	533,548	535,989	539,191	538,873	535,991	536,682	549,474	540,175
Amortization	56,250	56,500	56,750	57,000	57,250	57,500	57,750	58,000
Total opex	2,634,525	2,632,110	2,735,155	2,705,797	2,686,240	2,715,491	2,833,763	2,796,952
Op Income	79,115	78,436	111,792	103,542	104,090	112,972	137,523	137,066
Interest Exp	45,750	45,500	45,250	45,000	44,750	44,500	44,250	44,000
Other interest	346	239	94	654	333	330	353	418
FX loss	1,853	2,317	(2,041)	419	637	333	(163)	306
Deriv. loss	-	-	-	-	-	-	-	-
Pretax Inc	31,166	30,380	68,489	57,469	58,370	67,809	93,083	92,342
Income taxes	4,207	4,101	9,246	7,758	11,674	13,562	18,617	18,468
Net Income	26,958	26,279	59,243	49,711	46,696	54,247	74,467	73,873
Diluted shares	262,000	262,000	262,000	262,000	262,000	262,000	262,000	262,000
Diluted EPS	0.10	0.10	0.23	0.19	0.18	0.21	0.28	0.28

## Y/Y change

	FQ1 06E	FQ2 06E	FQ3 06E	FQ4 06E	FQ1 07E	FQ2 07E	FQ3 07E	FQ4 07E
Total revenues	103%	1%	1%	1%	3%	4%	4%	4%
COGS	102%	0%	0%	2%	2%	4%	4%	4%
SG&A	103%	1%	-4%	-1%	0%	0%	2%	0%
Amortization	122%	2%	-1%	0%	2%	2%	2%	2%
Total opex	103%	0%	0%	1%	2%	3%	4%	3%
Op Income	119%	30%	67%	14%	32%	44%	23%	32%
Interest Exp	205%	2%	-3%	-2%	-2%	-2%	-2%	-2%
Other interest	-55%	-71%	-104%	-66%	-4%	38%	276%	-36%
FX loss	n/a	-88%	-83%	n/a	-66%	-86%	-92%	-27%
Deriv. Loss	-100%	-100%	n/a	n/a	n/a	n/a	n/a	n/a
Pretax Inc	72%	-973%	100%	34%	87%	123%	36%	61%
Income taxes	n/a	696%	n/a	n/a	177%	231%	101%	138%
Net Income	21%	-758%	49%	8%	73%	106%	26%	49%
Diluted shares	9%	0%	0%	2%	0%	0%	0%	0%
Diluted EPS	10%	n/a	49%	5%	73%	106%	26%	49%

## As % of sales

	FQ1 06E	FQ2 06E	FQ3 06E	FQ4 06E	FQ1 07E	FQ2 07E	FQ3 07E	FQ4 07E
Total revenues	100%	100%	100%	100%	100%	100%	100%	100%
COGS	75%	75%	75%	75%	75%	75%	75%	75%
SG&A	20%	20%	19%	19%	19%	19%	18%	18%
Amortization	2%	2%	2%	2%	2%	2%	2%	2%
Total opex	97%	97%	96%	96%	96%	96%	95%	95%
Op Income	3%	3%	4%	4%	4%	4%	5%	5%
Interest Exp	2%	2%	2%	2%	2%	2%	1%	1%
Other interest	0%	0%	0%	0%	0%	0%	0%	0%
FX loss	0%	0%	0%	0%	0%	0%	0%	0%
Deriv. loss	0%	0%	0%	0%	0%	0%	0%	0%
Pretax Inc	1%	1%	2%	2%	2%	2%	3%	3%
Income taxes	0%	0%	0%	0%	0%	0%	1%	1%
Net Income	1%	1%	2%	2%	2%	2%	3%	3%

b. Annual projections.

	F2005	F2006E	F2007E
Total revenues	9,617,544	11,080,472	11,524,098
COGS	7,267,653	8,333,485	8,639,624
SG&A	1,900,378	2,147,602	2,162,323
Amortization	195,308	226,500	230,500
Total operating expenses	9,363,339	10,707,587	11,032,447
Operating Income	254,205	372,885	491,651
Interest on LT Debt	152,730	181,500	177,500
Other interest	1,383	1,333	1,434
Unrealized FX loss	7,413	2,548	1,113
Unrealized loss on derivatives	884	-	-
Income before taxes	91,795	187,504	311,604
Income taxes	(12,583)	25,313	62,321
Net Income	104,378	162,191	249,283
Diluted shares	254,929	262,000	262,000
Diluted EPS	0.41	0.62	0.95
Y/Y change			
	F2005	F2006E	F2007E
Total revenues	216%	15%	4%
COGS	211%	15%	4%
SG&A	315%	13%	1%
Amortization	409%	16%	2%
Total operating expenses	230%	14%	3%
Operating Income	22%	47%	32%
Interest on LT Debt	1200%	19%	-2%
Other interest	-50%	-4%	8%
Unrealized FX loss	n/a	-66%	-56%
Unrealized loss on derivatives	n/a	n/a	n/a
Income before taxes	-53%	104%	66%
Income taxes	n/a	n/a	146%
Net Income	-21%	55%	54%
Diluted shares	12%	3%	0%
Diluted EPS	-30%	51%	54%

As % of sales

	F2005	F2006E	F2007E
Total revenues	100%	100%	100%
COGS	76%	75%	75%
SG&A	20%	19%	19%
Amortization	2%	2%	2%
Total operating expenses	97%	97%	96%
Operating Income	3%	3%	4%
Interest on LT Debt	2%	2%	2%
Other interest	0%	0%	0%
Unrealized FX loss	0%	0%	0%
Unrealized loss on derivatives	0%	0%	0%
Income before taxes	1%	2%	3%
Income taxes	0%	0%	1%
Net Income	1%	1%	2%