

Walgreens, CVS or Rite-Aid: Which Tenant Is Best?

By David Tran

There are 3 major drug-store chains in the US: Walgreens, CVS, and Rite Aid. The table below ranks the companies by market capitalization and sales as of January 2007:

- **Walgreens** ranks number 1 with market cap of \$46.0B, \$50.5B in revenue, 5611 stores and S&P rating of A+.
- **CVS** ranks number 2 with market cap of \$27.2B, \$44.5B in revenue, 6191 stores and S&P rating of BBB+.
- **Rite Aid** ranks number 3 with market cap of \$3.2B, \$17.3B in revenue, 3329 stores and S&P rating of B+.

Investors purchase properties occupied by these drugstore chains for these reasons:

1. The drugstore business is considered recession-proof. People need medicine when they are sick, regardless of the state of the economy. Both rich and poor people in the US have access to medicine. Some even argue that low-income people use more medicine because they get them for free from government programs.
2. The drugstore business has a good prospect in the US:

- People are living longer and need more medicine to help them live longer. Older people tend to use more medicine than younger ones. As the 78 million baby boomers are getting closer to retiring age, the drugstore chains anticipate the demand for medicine to increase in

next 20 years.

- The US population will continue to grow, and so the market will get bigger.

- There are new drugs to treat old or previously untreatable illnesses, and new diseases, e.g. Viagra, Zoloft for depression, Avastin for colon cancer, Herceptin for breast cancer, Nicotine patches for smokers to kick the habit, Tamiflu for a potential Bird Flu pandemic, Tekturna/Rasilez for hypertension and various new drugs for AIDS and Attention Deficit Disorder (ADD). The new medicines are very expensive, e.g. a year's supply of Avastin costs about \$55,000. Eli Lilly has sold about \$4.8 billion of Zyrpexa in 2007 for schizophrenia and yet most people have never heard of this medicine.

- Technology and modern life introduce and require new products, e.g. pregnancy test kits, diabetic monitors, electronic toothbrushes, contact lenses, lenses cleaners, diet pills, vitamins, birth-control pills, IUDs, nutrition supplements and Cholesterol-lowering pills (Americans spent nearly \$26B in 2006 on Cholesterol medications alone per IMS Health, a Connecticut-based consulting company that monitors pharmaceutical sales.) There are also more surgeries: C-sections, Kidney transplants, open-heart triple by-pass, and breast augmentations. More surgeries mean more medicines needed: potent pain killers, and Warfarin to prevent blood clots in

surgeries .

- Before the customers can get to the medicine aisles or pharmacy counters, they have to pass by chocolates, sodas, digital cameras, watches, toys, dolls, wines, cosmetics, video games, flowers, fragrances, etc. As a result, customers buy more than their prescriptions and medicine in these drugstores. CVS reported that non-pharmacy sales represented 30% of the company's total sales in January of 2007. The figure for Walgreens is 34%.

3. These companies sign very long-term, NNN leases, guaranteed by their corporate assets. This makes the investment in the underlying property fairly low risk, especially for Walgreens with an A+ debt rating. In fact, these properties are sometimes referred to as investment-grade properties. Once the drugstore chains sign the lease, they will pay the rent no matter what. The authors are not aware of any properties leased by one of these drugstore chains in which the tenants failed to pay rents. Even when the stores are closed due to weak sales (Walgreens closed 119 stores last quarter), these companies may sublease to another company and continue to pay on the main lease.

Walgreens

Walgreen Company was founded in 1901 by Charles Walgreen, Sr. in Chicago. While the company has existed for more than 100 years, most stores are only 5-10 years



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old. The company plans to open 500 new stores in 2007. This is the best managed company among the three drugstore chains and also among the most admired public companies in the US. Due to its superior financial strength and premium locations, properties with leases from Walgreens get the highest price per square foot among the 3 drugstore chains. In addition, Walgreens gets a flat rent or very low rent increase for 20 to 30 years. The cap rate is often in the 5% range for properties in California and up to 6.5% outside of California. Investors who buy properties leased by Walgreens look for a safe investment. They often compare the returns on their investment with the returns from US treasury bonds or Certificate of Deposits from banks.

CVS Pharmacy

CVS Corporation was founded in 1963 in Lowell, MA by Stanley Goldstein, Sidney Goldstein, and Ralph Hoagland. The name CVS stands for "Consumer Value Stores". It now has close to 6,200 stores in the US, mostly through acquisitions. In 2004, CVS bought 1,200 Eckerd Drugstores mostly in Texas and Florida. In 2006, CVS bought 700 Savon and Osco drugstores mostly in Southern California. It is also buying Caremark, the largest pharmaceutical services company. When CVS bought 1,200 Eckerd stores, it formed a single-entity LLC to own each Eckerd store. Each LLC signs the lease with the property owner. In the event of a default, the owner collects only from the assets of the LLC and not from any other CVS-owned assets. Although the owner loses the security from CVS corporate assets, the authors are not aware of any incident where CVS closes a store and does not pay rent.

Rite-Aid

Rite Aid opened its first store in 1962 as "Thrift Discount Center" in Scranton, Pennsylvania. It officially incorporated as Rite Aid Corporation in 1968. Rite Aid is the weakest financially among the 3 drugstore chains. It had

serious financial problems just a few years ago. However, the worst seems to be over. Rite-Aid is acquiring (as of Feb 07) about 1,850 Brooks and Eckerd drugstores, mostly along the East coast to catch up with Walgreens and CVS. After the acquisition, Rite-Aid will have about 5,000 stores and nearly \$27 Billion in revenues.

Do's and Don'ts:

If you are interested in investing in a property leased by drugstore chains, here are a few things you should consider:

3. If you want a low risk "bullet-proof" investment, go with Walgreens. The degree of safety is the same whether the property is in California where you get a 5% cap or Texas where you may get a 6.5% cap. So, there is no significant advantage to invest in properties in California.

4. If you are willing to take more risk, then go with Rite-Aid. Some properties outside of California may offer up to 8% cap rate.

5. All 3 drugstore chains have similar requirements. They all want highly visible, standalone, rectangular property around 12,000 - 14,000 SF on a 1.5 - 2 acre lot, preferably at a corner with about 75 - 80 parking spaces in a growing and high traffic location. They all require the property to have a drive-thru. Hence, you should avoid purchasing an inline property, i.e. not standalone and property with no drive-thru, as there is a chance that these drugstores may not want to renew the lease. In addition, if you acquire a property that does not meet the new requirements, for example a drive-thru, you may have a problem getting financing as lenders are aware of these requirements.

6. If the pharmacy is opened 24 hours a day, it is in a better location. Drugstore chains do not open the store 24 hours day unless the location draws customers.

7. Some properties may have a percentage lease. If so, you want to determine the store's

sales figures. Of course, you want to invest in a location where the store's sales are higher than the average for that drugstore chain.

8. Many properties have an existing loan that the buyer must assume. If you have a 1031 exchange, do not buy this property. Should you fail to assume the existing loan (because assuming an existing loan is a lot more difficult than getting a new loan), you may run out of time for a 1031 exchange and have to send a big check to the IRS.

About 10% of the drugstore properties for sale and typically CVS pharmacies allow an investor to down less than 15% of the purchase price but require the investor to assume an existing fully-amortized loan with zero cash flow. That is, all of the rent paid by the tenant must be used to pay down the loan. The cap rate may be in the 7% range, and the interest rate on the loan could be in the 5.5% to 6% range. Hence, the investor pays off the loan in 10 to 20 years. However, the investor has no positive cash flow during the year, which forces him to pay income tax on any rental profits (the difference between the rent, mortgage

interest and other operating costs) from outside sources and not from the property's rental activity. The longer you own the property, the more outside cash you will need to pay income taxes as the mortgage interest will get less and less toward the end. So who would buy this kind of property?

- The misinformed investors who failed to consider that they have to raise additional cash to pay income taxes.

- The investors who have rental losses from other properties. By acquiring this zero cash flow property, they may offset the income from the drugstore tenant against the rental losses from other properties. For example, a property has \$105,000 of rental profits a year, and the investor also has rental losses of \$100,000 from other properties. As a result, the combined profits are only \$5,000.

- The investors who are motivated by a low down payment and high cap rate.

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