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Australian Pharmaceutical Industries (API)

WOW Gets Cold Feet

Recommendation
Hold (unchanged)
Price
$1.51
Target (12 months)
$1.53 (previously $1.73)

GICS Sector

Healthcare Equipment and Services

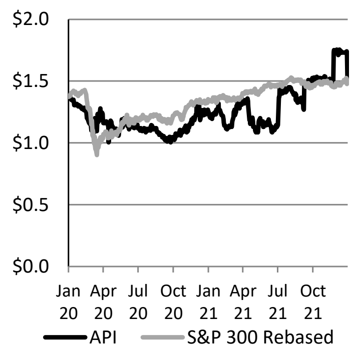
Expected Return	
Capital growth	**1.3%**
Dividend yield	**1.3%**
Total expected return	**2.6%**

Company Data & Ratios	
Enterprise value	**$945.1m**
Market cap	**$745.1m**
Issued capital	**492.7m**
Free float	**100%**
Avg. daily val. (52wk)	**$2.6m**
12 month price range	**$1.06 - $1.77**

Price Performance

	(1m)	(3m)	(12m)
Price (A$)	1.75	1.51	1.26
Absolute (%)	-13.18	0.33	20.24
Rel market (%)	-16.49	-2.42	8.10

Absolute Price



SOURCE: IRESS

WOW unable to make the numbers stack up

Following completion of due diligence the WOW Board has decided to withdraw its cash bid for API. The bid, which was highly conditional and non-binding, had the support of the API Board. API will now proceed with the WES bid at $1.55 (less the 2 cps final dividend).

The notice from WOW withdrawing the bid is brief on detail citing only that the company had not been able to validate the financial return it requires. Fair enough, however, one wonders what, if anything, was uncovered during the due diligence process that led to this conclusion. The key risks in the transaction related to the ACCC sign off, WOW's future interaction with the Pharmacy Guild and the 19.3% blocking stake held by Wesfarmers. These should have been identified prior to the bid and the due diligence exercise itself should have been relatively straight forward.

The WOW bid valued API at ~$1.01bn (Enterprise value) which implied a year 1 return on invested capital (based on BPe for FY23) of ~7% before any synergy savings or other value add. So why did WOW and before them SIG pull out? In SIG's case it is not unreasonable to assume its internal management issues (which have since emerged) were a contributing factor, while for WOW the potential of a modest 7% return on capital combined with a likely protracted period of less than 100% ownership of API may have contributed. WOW may have been required to pursue a messy takeover bid rather than the more efficient Scheme of Arrangement (SoA). All of these factors were in plain sight at the time of the WOW bid announcement, hence API investors can quite rightly only ponder the motivation of the ill fated WOW bid.

Investment View: Retain Hold, Price Target reduced to $1.53

No changes to earnings. Price target reduced to $1.53 matching the WES cash offer (after the 2 cps final dividend). If anything the episode highlights the superior strategy of the WES group in establishing its 19% holding prior to going to public with its bid. We now expect the WES Scheme meetings to proceed later this quarter. The WES bid remains subject to ACCC sign off and the normal SoA approvals.

Earnings Forecast

August Year End	FY21	FY22e	FY23e	FY24e
Revenues	4,004.0	4,095.1	4,112.8	4,136.1
EBITDA $m	104.8	115.1	147.7	118.1
NPAT (underlying) $m	39.4	44.0	63.3	44.1
NPAT (reported) $m	1.2	40.5	63.3	44.1
EPS underlying (cps)	7.8	8.9	12.7	8.9
EPS growth %	72%	13%	44%	-30%
PER (x)	19.3	17.1	11.9	17.0
FCF yield (%)	3.5%	7.5%	12.8%	10.3%
EV/EBITDA (x)	9.0	8.2	6.4	8.0
Dividend (cps)	3.5	4.4	6.4	5.8
Franking	100%	100%	100%	100%
Yield %	2.3%	2.9%	4.2%	3.8%
ROE %	0.3%	8.8%	12.9%	8.6%

SOURCE: BELL POTTER SECURITIES ESTIMATES

Australian Pharmaceutical Industries (API)

- API is vertically integrated wholesaler, franchise owner and retailer.
- The wholesale business services a portion of Australia's ~5,350 community pharmacies. Its core business is to acquire pharmaceuticals from originators and other manufacturers for distribution to pharmacy.
- Most aspects of the wholesale business are heavily regulated, yet despite recent industry restructure, API has continued to manager the profitability of the business through margin clawback. The clawback period is now at end, hence no further margin improvement is possible.
- The jewel in the crown for API is the Priceline Pharmacy chain. With 495 stores and more than 7.0 million members in the loyalty program, the business is a powerful retail presence. The company continues to invest heavily in marketing spend and remaining at the forefront on product innovation and product and brand renewal.
- Target price is determined via capitalised earnings model with the cross check of a DCF model.
- In 2019 the company acquired a majority ownership of the Clearskin Clinics business which is hopes to grow through new store openings and enhanced product offerings.

Key Risk Areas

- **Regulatory risk** - key aspects of the company's business are subject to Federal Government regulation. Further adverse change to the PBS for example may adversely impact the company's ability to realise our forecast earnings.
- **Relationship with Franchisee's** - The retail business is dependent upon the ongoing support of Franchisee's. Each of the full line distributors are eager to source successful pharmacy operators hence API needs to keep the offering to them competitive.
- **Generic Pharmaceuticals** - The growth of generic pharmaceuticals will continue to erode margins in the pharmacy wholesale business.
- **Bad Debt Risk** – API is exposed to any increase in pharmacy bad debt. There is an elevated risk bad debt levels may increase due to the ongoing changes in the PBS. Bad debt expense each year is already material to NPAT. Mitigating this risk, API always strives to gain security over anything other than standard trading terms.

Australian Pharmaceutical Industries
as at 7 January 2022

Recommendation	Hold
Price	$1.51
Target (12 months)	$1.53

Table 1 - Financial summary

Profit & Loss (A$m)	FY20	FY21	FY22e	FY23e	FY24e
Year Ending August					
Total revenues *	4,019.6	4,004.0	4,095.1	4,112.8	4,136.1
Revenues growth	0.2%	-0.4%	2.3%	0.4%	0.6%
Gross profit	**474.5**	**494.5**	**520.9**	**547.3**	**552.2**
EBITDA	83.2	104.8	115.1	147.7	118.1
EBITDA margin %	2.1%	2.6%	2.8%	3.6%	2.9%
Depreciation	17.7	17.4	17.5	24.0	24.0
Amortisation	13.3	17.4	18.0	18.0	18.0
EBIT (ex one one off costs)	**52.2**	**70.0**	**79.6**	**105.7**	**76.1**
EBIT margin %	1.3%	1.7%	1.9%	2.6%	1.8%
Net interest	(19.1)	(15.3)	(16.7)	(15.2)	(13.0)
Pre tax profit	**33.1**	**54.7**	**62.9**	**90.5**	**63.1**
Tax expense	(9.9)	(15.3)	(18.9)	(27.2)	(18.9)
NPAT- normalised	23.2	39.4	44.0	63.4	44.2
Net abnormal items	(31.1)	(38.2)	(3.5)	-	-
Reported NPAT	-7.9	1.2	40.5	63.4	44.2
Attributable to Parent	-8.4	0.7	40.5	63.4	44.2

Cashflow (A$m)	FY20	FY21	FY22e	FY23e	FY24e
Gross cashflow	239.5	100.8	152.9	168.7	139.1
Net interest	(13.0)	(10.1)	(16.7)	(15.2)	(13.0)
Other specials	-	-	-	-	-
Tax paid	(10.9)	(18.9)	(14.8)	(24.9)	(20.9)
Operating cash flow	215.6	71.8	121.4	128.6	105.3
Capex	(39.9)	(45.9)	(63.0)	(31.4)	(26.0)
Free cash flow	175.7	25.9	58.4	97.2	79.3
Acquistion of intangibles	-	-	(3.0)	(3.0)	(3.0)
Other - investing	-	-	-	-	-
Other investing cash flows	81.0	(32.9)	-	-	-
Asset sales	10.0	9.9	-	-	-
(Reduction)/Increase in borrowings	(219.0)	(19.3)	(34.2)	-	-
Dividends paid	(19.9)	(17.4)	(17.4)	(33.4)	(24.3)
Other	4.6	16.7	-	-	-
Change in cash held	32.4	(17.1)	3.8	60.8	52.0
Cash at beginning of period	28.2	56.1	38.8	42.6	103.4
Cash at year end	**60.7**	**38.8**	**42.6**	**103.4**	**155.3**

Balance Sheet (A$m)	FY20	FY21	FY22e	FY23e	FY24e
Cash	60.7	38.8	42.6	103.4	155.3
Receivables	537.9	589.1	585.0	587.5	590.9
Inventory	368.2	353.0	348.4	348.9	351.9
Other current assets	6.5	8.9	8.9	8.9	8.9
Property, Plant and Equipment	109.8	109.8	155.3	162.7	164.7
Intangible assets	264.4	255.3	240.3	225.3	210.3
Other non current	46.1	32.0	30.0	22.0	16.0
Deferred tax assets	20.6	22.1	22.1	22.1	22.1
Other	125.7	121.0	106.0	91.0	76.0
Total assets	1,539.9	1,530.0	1,538.7	1,571.8	1,596.1
Trade payables	775.5	719.6	735.2	736.1	742.5
Provision for income tax	-	-	4.1	6.3	4.4
Debt (including leases)	260.8	314.2	280.0	280.0	280.0
Other liabilities	48.9	55.7	55.7	55.7	55.7
Total Liabilities	1,085.2	1,089.5	1,075.0	1,078.2	1,082.6
Net Assets	454.7	440.5	463.7	493.6	513.5
Share capital	566.5	566.5	566.5	566.5	566.5
Retained earnings	96.9	81.2	104.4	134.3	154.2
Reserves	(212.5)	(208.9)	(208.9)	(208.9)	(208.9)
Profits reserve	-	-	-	-	-
Shareholders Equity	450.9	438.8	461.9	491.9	511.7
Minority Interest	3.8	1.7	1.8	1.7	1.8
Total Equity	454.7	440.5	463.7	493.6	513.5

Valuation Ratios (A$m)	FY20	FY21	FY22e	FY23e	FY24e
Year Ending August					
Reported EPS (cps) -	1.7	0.1	8.2	12.8	8.9
Normalised EPS (cps)	4.6	7.8	8.9	12.8	8.9
EPS growth (%)	-39%	72%	13%	44%	-30%
PE(x)	33.1	19.3	17.1	11.9	17.0
EV/EBITDA (x)	11.4	9.0	8.2	6.4	8.0
EV/EBIT (x)	18.1	13.5	11.9	8.9	12.4
NTA (cps)	39	38	46	55	62
P/NTA (x)	3.9	4.0	3.3	2.8	2.4
Book Value (cps)	93	90	95	101	105
Price/Book (x)	1.6	1.7	1.6	1.5	1.4
DPS (cps)	2.0	3.5	4.4	6.4	5.8
Payout ratio %	44%	45%	50%	50%	65%
Dividend Yield %	1.3%	2.3%	2.9%	4.2%	3.8%
Franking %	100%	100%	100%	100%	100%
FCF yield %	23.8%	3.5%	7.5%	12.8%	10.3%

Performance Ratios					
ROA	-0.5%	0.1%	2.6%	4.0%	2.8%
ROE	-1.7%	0.3%	8.7%	12.8%	8.6%
ROIC	5.2%	6.6%	7.6%	9.7%	6.8%
Average net debt/Equity	81.4%	96.6%	87.9%	70.2%	57.4%
Net debt/Assets	13.0%	18.0%	15.4%	11.2%	7.8%
Gearing	30.6%	38.5%	33.9%	26.4%	19.5%
Net debt/EBITDA	2.4	2.6	2.1	1.2	1.1
Interest cover (x) EBIT/NI	2.7	4.6	4.8	7.0	5.9

Segement Results	FY20	FY21	FY22e	FY23e	FY24e
Pharmacy - external sales	2,977.0	3,011.0	3,034.5	3,051.0	3,070.3
Growth	3.9%	1.1%	0.8%	0.5%	0.6%
Wholesale GP	211.0	217.0	223.9	244.1	245.6
Retail Rev (incl disp)	939.0	875.0	924.3	981.2	981.2
Growth	*-8.3%*	*-6.8%*	*5.6%*	*6.2%*	*0.0%*
Retail GP	204.5	216.0	221.8	235.5	235.5
Manufacturing Rev	63.3	63.0	63.0	-	-
Manufacturing GP	25.3	13.5	13.5	-	-
Clearskin Clinics Revenues	40.3	55.0	73.3	80.6	84.7
Growth	-12%	36%	35%	10%	5%
Clearskin GP	33.7	48.0	61.6	67.7	71.1
Total revenues	4,019.6	4,004.0	4,095.1	4,112.8	4,136.1
Total GP	**474.5**	**494.5**	**520.9**	**547.3**	**552.2**
Warehouse & Distribution	145.5	143.1	141.6	143.1	149.9
Marketing & sales	190.0	192.3	193.0	193.5	220.8
Admin and General	111.4	95.1	114.6	112.9	113.4
Other income	-7.0	-6.0	-8.0	-8.0	-8.0
Add back: One off costs	(17.6)	0.0	-	-	-
EBIT	**34.6**	**70.0**	**79.6**	**105.7**	**76.1**

Interim results (A$m)	1H21	2H21	1H22e	2H22e
Total revenues *	1,980.5	1,920.2	2,129.5	1,965.7
EBIT	29.4	40.6	41.4	38.2
Net interest	(7.5)	(7.8)	(8.0)	(8.7)
Pre tax profit	21.9	32.8	33.4	29.5
Tax expense	(5.9)	(9.4)	(10.0)	(8.9)
NPAT- normalised	16.0	23.4	23.4	20.7

SOURCE: BELL POTTER SECURITIES ESTIMATES

Recommendation structure

Buy: Expect >15% total return on a 12 month view. For stocks regarded as 'Speculative' a return of >30% is expected.

Hold: Expect total return between -5% and 15% on a 12 month view

Sell: Expect <-5% total return on a 12 month view

Speculative Investments are either start-up enterprises with nil or only prospective operations or recently commenced operations with only forecast cash flows, or companies that have commenced operations or have been in operation for some time but have only forecast cash flows and/or a stressed balance sheet.

Such investments may carry an exceptionally high level of capital risk and volatility of returns.

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