

# TRANSMERCIAL REAL ESTATE INVESTMENTS NEWSLETTER

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## Should You Buy a Walgreens Drugstore in 2024?

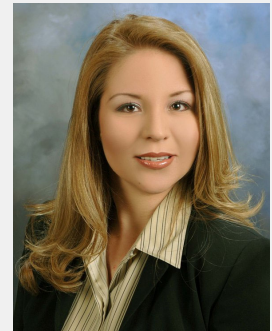
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Lately there have been quite a few Walgreens on the market for sale. Some of them are located in high income and growing areas, e.g. Durham, Atlanta, Houston. The offering cap rates are high, in the 7-8.5% range. The leases are absolute triple net which means there are no landlord responsibilities. Some sellers even offer to pay buyer's brokers up to 5% commission --compared to just 1% a few years ago -- to sell these Walgreens. Before you consider acquiring these drugstores, you need to understand its business so you can assess the investment risks.

After a drugstore dispenses a prescription, it receives a payment from Pharmacy Benefit Managers (PBMs), not from health insurance company that most people believe. The 3 PBMs --Caremark, Express Scripts and OptumRx -- control about 80% of the prescriptions in the US. PBMs are middlemen between drug stores and health insurance companies & drug companies. They negotiate with health insurance companies to determine payments, what drugs are on the formulary (approved drug list) for different insurance plans, the co-payment, etc. They in turn negotiate with pharmaceutical companies on how much discounts from the listed prices for the drugs. Drugstores enter the prescriptions on the computers. PBMs then process the drug claims and then reimburse the drugstores for the prescriptions. In addition, PBMs operate mail-order pharmacies (in warehouses with low occupancy costs) and specialty pharmacies that handle drugs that are high-cost (high profit margin) or complex to dispense, e.g. drugs that treat some cancers, inflammatory conditions like rheumatoid arthritis, and viral infections like HIV and Hepatitis C, bypassing retail pharmacies like Walgreens and CVS. So drugstores are at the mercy of PBMs. PBMs decide how much to reimburse drugstores. Lately, they seem to reimburse less. As a result, Walgreens reported 6.2% higher prescription revenue but also reported a loss of \$13.2 billion for the quarter (\$12.4 B from non-cash impairment charge related



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to VillageMD goodwill). And so, you will see more Walgreens drugstores listed for sale as landlords worry that Walgreens will shut down their stores. CVS is also affected but not as much as Walgreens as it owns Caremark, the biggest PBM that controls 33% of the market share. CVS acquired Caremark in 2007 for \$26.5 billion. To make the matter worse, Walgreens, CVS and Walmart had to settle in 2023 with many states on opioids litigation. CVS has to pay up to \$4.9 billion over 7 years, Walgreens \$5.52 billion over 15 years, and Walmart \$2.74 billion in 6 years. As result, Walgreens has been downgraded from BBB to BBB-, just one grade above junk by S&P.

The drugstore business also has a new giant player, Amazon Pharmacy (AP). It plans to bypass PBMs. PBMs have huge databases of patients' information, insurance plans, approved drugs for each insurance plan, drug companies and billing information. To bypass PBMs, AP will have to develop these databases. The databases are stored in the cloud which is also Amazon's main business and an area of its expertise. PBMs handle billings/insurance claims which Amazon does it probably better than any company. While the drug mail-order business is just about 10% of the total market share due to the 7-10 days it takes PBMs to deliver, AP can do it as little as 3 minutes in some markets using drones. Like the retail business, Amazon Pharmacy covers a few major cities initially. It then gradually expands and uses Artificial Intelligence (AI) and robots to make the process more efficient and less prone to errors. So AP's market share will increase as more patients will use its mail-order drug business to save time and money. AP will disrupt and become a dominant player in the drugstore business in the future just like what it has achieved in the retail business.

As Walgreens is not profitable and its business outlook is negative per analysts. While the new Walgreens CEO, Tim Wentworth, a former CEO of Express Scripts, a PBM, understands the challenges Walgreens faces, it's not clear whether he can come up with solutions to turn around Walgreens. Walgreens will have to find a way to cut expenses. Walgreens may do some of the following that will affect its landlords:

1. Shut down more locations in the future.
2. Defer maintenance to reduce expenses: instead of repaving the parking lot and painting the property every 5-7 years, it may wait till year 10.
3. Ask the landlord for a concession on capital ex-

penses for lease renewal. It may ask the landlord to contribute to roof and/or HVACs replacement or ask the landlord to amortize the capital expenses over many years.

4. Ask the landlord for a temporary rent reduction, especially on properties with higher than market and/or expensive rent.

**Conclusion:** Walgreens drugstores used to be a safe investment for older investors who just wanted to make sure they receive the rent checks on time each month. But now Walgreens landlords could lose sleep as it faces many financial and business challenges.

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