Albertsons and Rite Aid to merge in the latest move to contrast the growing threat posed by online e-commerce

Rite Aid (NYSE:RAD) – market cap as of 23/02/2018: $2.22bn

Introduction

On the 20th February, Rite Aid Corporation, one of the leading US drugstore chains, entered into a definitive merger agreement with Albertsons Companies, one of the largest American private equity-backed grocery retailers. The deal will result in the creation of a company with a combined enterprise value of c. $24bn and expected revenues of $83bn this year.

Besides being part of the recent wave of consolidation characterizing the drug retailing sector, the deal can also be interpreted as a clear move against the potential entry of Amazon in the industry.

About Rite Aid Corporation

Rite Aid is a drugstore network and benefits-management group founded in 1968 and headquartered in Pennsylvania. The company operates approximately 4,560 stores in over 30 states across the United States and mainly operates in two segments: Retail Pharmacy and Pharmacy Services. The Retail Pharmacy segment sells brand and generic prescription drugs, as well as an assortment of front-end products. Moreover, through the two subsidiaries RediClinic and Health Dialog, it operates retail clinics and provides health coaching and healthcare analytics. The Pharmacy Services segment provides a range of transparent and traditional pharmacy benefit management (PBM) options through its EnvisionRx subsidiary and MedTrak PBMs. The company's performance highlights a P/E ratio of 20x, aligned to the industry benchmark of 20.8x according to Reuters, and an EBITDA margin of 2.7% in FYE17.

In October 2015, Rite Aid had already been target of a large takeover bid: one of the company's competitors, Walgreens, had indeed announced it would have acquired Rite Aid for an equity value of $9.8bn. However, after several delays and amendments to the original agreement mainly due to antitrust issues, the deal was abandoned in September 2017.

About Albertsons Companies

Albertsons Companies is one of the largest privately-owned grocery and drug retailers in the United States. It is backed by an investment consortium led by Cerberus Capital Management, L.P., which also includes Kimco Realty Corporation, Klaff Realty LP, Lubert-Adler Partners LP, and Schottenstein Stores Corporation. Albertsons is headquartered in Boise, Idaho and operates 2,323 stores across 35 states and the District of Columbia under 20 brands, such as Albertsons, Safeway, Vons, Jewel-Osco, Shaw's, Acme, Tom Thumb, Randalls, United Supermarkets, and many others. With a strong presence both at a local and national level, the Company's stores offer grocery products, general merchandise, health and beauty care products, pharmacy, fuel, and other items and services. Complementary to the large network of stores, the firm aims at providing its customers with a seamless omni-channel shopping experience by offering a growing set of digital services, including home deliveries, "click-and-collect" store pickup, and online prescription refills.

Founded in 1939 by Joe Albertson, the Company started as a mere grocery store under the name of Albertsons, Inc.; it then expanded to the first food/drug store combination in 1969 when Albertsons, Inc. partnered with Skaggs Drug Centers. During the 90s, the Company managed to grow in size thanks to an effective strategy of inorganic growth. However, the acquisition spree caused several integration problems to Albertsons, Inc. which led to a relevant change in 2006: the strongest division of the Company was sold to a consortium composed by SuperValu and CVS. What was left, instead, was purchased by the Cerberus-led group and renamed Albertsons, LCC on 2 June 2006, when the acquisition was completed and the Company was delisted. In the following years, backed by Cerberus Capital Management, Albertsons continued to seek deals, including the acquisition of SuperValu (2013) and the massive merger with Safeway (2015), which led to an increase in revenues from $7billion in FY12 to $61billion in FY18E (excluding the revenue contribution of Rite Aid).

Industry Overview

Over the past years, the healthcare's industry subsegment including pharmacies and drug retailing stores has exhibited growth despite some negative side effects due to significant external competition and uncertain political outlook.

During the last decades, the increasingly aging population and raising health consciousness among the global populace have driven the growth of the pharmaceutical and drug retailing sectors (especially in the US), which is forecasted to grow in size at CAGR of 3.6% over the next five years. Moreover, being the drug industry a highly fragmented one as well as highly dependent upon macroeconomic factors such as GDP and disposable income, a great potential for boost in demand from APAC regions is expected by analysts, due to the increasing industry share of Asian economies in world trade and the rapid industrialization in emerging economies.

If on the one hand prospects of growth in the pharmaceutical production and drug-making businesses are positive, on the other hand it is also true that major traditional drug retailers are experiencing shrinking margins and subsequent generous bidding offers. The reasons being two: firstly, the increasing competition derived from alternative competitive business models including supermarkets, niche health and beauty retailers, discount department stores and general merchandise stores that try to enhance their front-end sales by including drugs in their portfolio of products sold. And secondly, the threat of disruption represented by technology companies willing to enter the traditional supply chain markets and taking a bite of the distribution channel-related margins. In particular, Amazon's move to team up with Berkshire Hathaway and JPMorgan to form a not-for-profit company to provide health care for their employees is challenging the existing healthcare system and fueling a strong wave of consolidation across drug retailers. The phenomenon is particularly strong in the US, where drug store chains came into action after years of declining in traffic and sales through traditional brick-and-mortar stores.

Deal Structure

The two companies will combine in a cash-and-shares transaction that will create an entity of $24bn including debt. Albertsons' investors will retain approximately 71% of the combined entity, with the remainder being held by Rite Aid's shareholders. The merger has received the unanimous approval by the boards of directors of the two companies and the transaction is expected to close early in the second half of 2018, subject to regulatory approvals. Finally, after the closing of the transaction, Albertsons' shares are expected to trade on the New York Stock Exchange.

Under the terms of the agreement, for every 10 shares of Rite Aid common stock, shareholders can choose to receive either one common stock of Albertsons Companies, plus around $1.83 in cash, or 1.079 shares of Albertsons Companies. According to the decision of the existing shareholders, Rite Aid will hold a percentage of the combined company capital that ranges between 28.0% to 29.6% and current Albertsons shareholders will own between 70.4% to 72.0% on a fully diluted basis. As the termination fees agreement rules, the transaction can be terminated by a mutual decision in the event that the merger is not closed by August 18, 2018, with a potential extension of the term until November. Bank of America Merrill Lynch, Credit Suisse and Goldman Sachs are providing debt financing: $6bn will be delivered through a revolving credit facilities, while $2.4bn will be provided in equal part as an asset-based term loan facility and as a newly-secured bridge loan facility.

From an operational point of view, the integrated firm will manage approximately 4,900 locations, 4,350 pharmacy counters - rebranded as Rite Aid - and 320 clinics across 38 states and Washington, D.C. The combined entity will serve 40+ million customers per week.

Deal Rationale

This deal follows the wave of consolidation in the drug retailing sector: in light of recent decreases in sales volumes at front-end stores, players like Albertsons are pursuing cost-cutting and lower generic drug prices by acquiring similar players in the industry. Examples of this include the acquisition of Aetna by CVS Health or the interest recently expressed by Walgreens towards AmerisourceBergen. In the case of Albertsons and Rite Aid, the deal is expected to create "a leader in food, health and wellness" - as Albertsons CEO Robert Miller pointed out - and to generate annual run-rate cost savings of $375m.

Furthermore, the deal can be explained as a defensive move against the entry of Amazon in the drug retail industry, where traditional retail players must now strive to remain competitive. The e-commerce giant's last moves represent a serious threat to traditional retail players: the acquisition of Whole Foods Market in 2017 marked a strong willingness to gain a dominant position in the grocery store business, while the agreement reached with JPMorgan and Berkshire Hathaway represents a clear step towards the healthcare industry.

Finally, the deal represents a way for Albertsons' private equity owner, Cerberus Capital Management, to finally exit its decade-long investment, bringing the chain onto the public market; this would be the second, big attempt after the IPO which was planned for 2015 but never launched due to macro and industry-related adverse conditions.

Market Reaction

Rite Aid's stock initially surged (+25%) premarket on Tuesday, eventually trading up 2.3% at $2.18 for the rest of the day. This clearly signals a positive attitude of the market towards the deal: investors indeed are confident that, differently from Walgreens in 2015, Albertsons will manage to finalize the acquisition and extract the related benefits expected.

Advisors

Credit Suisse, Goldman Sachs and Bank of America Merrill Lynch served as lead financial advisors to Albertsons Companies, while also providing committed financing for the proposed transaction. Citi was the exclusive financial advisor to Rite Aid.