Walgreens acquires Rite-Aid

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Mergers and Acquisitions

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I.Executive Summary:

Rite-Aid (NYSE:RAD) is the target in this acquisition and is one of the smaller sized companies in the pharmaceutical retailing industry. Rite-Aid is one of the nation's leading drugstore chains with roughly 4,600 stores located in the United States and the District of Columbia. However, over the past few years, Rite-Aid has had difficulties in achieving scale and stores have been underperforming. We believe a merger between Rite-Aid and Walgreens would be beneficial for both sides to help each other be more competitive within this industry.

Walgreens Boots Alliance (NASDAQ:WBA) is the acquirer in this acquisition attempt and is a leading player in the American pharmaceutical retailing industry. Walgreens is a relevant player in the industry, being the largest drug retailing chain in the United States. It is a top performer in the pharmaceutical industry, closely trailing behind CVS Health. The merger will effectively increase consumers access to pharmacies and pharmacy benefit managers (PBMs) and is expected to provide Rite Aid with the financial cushion to reinvest in its stores.

Walgreens is more attractive than other potential acquirers such as CVS Health because it has a greater understanding of our business and our mission. This knowledge will allow Walgreens to work with us to fit into their operations strategically. Looking ahead of this acquisition, ideally, lies the opportunity to take on CVS Health, using the combined 12,000 locations to take on CVS' 8,300 locations. This combination will also further strengthen the commitment to making quality healthcare accessible to more customers and patients. It will also create an even better network in which there are more solutions to health and wellness online and in stores. Our philosophies are able to be integrated together to ultimately improve quality healthcare in the United States.

One of the key risks with this acquisition would have to be the possibility of losing employees. Employees are most at risk of being lured away by our competitors (CVS, PharMerica) because of the uncertainty and fear of job loss that comes with change. Along with the risk of losing employees, there is also the trouble of retaining employees after making the necessary changes in regards to their bonuses, salaries, and compensation plans.

Another major risk would be the clashing of each company's culture. How well will the employees of Rite-Aid take joining a pharmaceutical retailing giant is something to be wary of, as well as the how the employees of Walgreens view the new members. This is something that can be avoided depending on how transparent the company is about this transaction, but could also backfire for the lack of transparency.

The total acquisition cost is $9.4 billion. We have calculated the maximum offer price to be $10.84 per share. Realistically Walgreens will offer $9 per share. This amount represents a 48% premium on the closing price. We expect the transaction to be financed mainly through Walgreen's existing cash and debt.

II.Target stand-alone prospects and industry dynamics

A) Industry/market definition:

Founded in 1962 and headquartered in Camp Hill, PA, Rite-Aid Corporation operates a chain of retail drugstores. It is the largest drugstore chain on the East Coast and the third-largest in the US. The company sells prescription drugs and a wide range of other merchandise such as, over-the-counter (OTC) medications, health and beauty aids, personal care items, cosmetics, household items, beverages, convenience foods, greeting cards, seasonal merchandise, photo processing and others. The company also has a technology which helps its customer to refill their prescription through internet under website www.riteaid.com. The company operates through subsidiaries and retail drugstores in the US. It operates 4,570 stores in 31 US states and the District of Columbia . According to its current 10-K government filing, the company had FYE 02/28/2015 revenue of $26.5 billion and has 89,000 employees. Major competitors include Wal-Mart, Safeway, Albertson's, Target, PharMerica, and CVS.

B) External Analysis:

Porter's Five Forces helps identify the bargaining power of customers, competitors, new entrants, suppliers, and substitutes. Customers in this industry have a moderate level of bargaining power because they have the option to choose where they go and the products they buy. The threat of competition is high because there are such large giants in the industry that have a lot of control, but there smaller companies that still succeed in competing. Rite Aid is the third largest in the industry and they hold a lot of the market share. Due to the fact that this industry has some heavy regulations, it is difficult for new entrants to gain significant market share. In the drugstore industry, 55.7% of suppliers feel that they are not in an equally beneficial relationship. This indicates how suppliers have low bargaining power because big giants like Walgreens will not be affected by the loss of one supplier. Lastly, the threat of substitutes are high because there are companies that are selling products for cheaper prices, which are more appealing for customers. This industry will grow as it successfully appeals to the aging population.

C) Internal Analysis:

- Strength - Large Retail Network

  Rite Aid has operations spread over large part of the US. Such a broad presence provides the company with the significant advantage to cover large population of patients to earn more revenues. The company operates a total of 4,570 stores in 31 states across the US and the District of Columbia. These stores are present in diverse markets, with majority of them in urban, high traffic areas and also in lower traffic suburban or rural areas. The overall average size of a store in Rite Aid's chain is around 12,600 sq ft. Rite Aid employs 89,000 associates to undertake the operations in the stores. Rite Aid is recognized as the third largest drugstore chain in the US in terms of revenues and number of stores. With such this extensive store network, the company has an advantage over its competitors in the marketing of drugs as well as other services.

- Strength - Market Leadership

  A strong position in retail drugstore market, coupled with its diverse range of offerings, helps Rite Aid to tap the immense market potential in the healthcare market space. Rite Aid is one of the largest retail drugstore chains in the US. It is the third largest retail drugstore chain in the US based on both revenues and number of stores. The company operates through 100% owned subsidiaries and retail drugstores in the US. As of February 2015, it operated 4,570 stores in 31 states across the country and in the District of Columbia. Its drugstores' primary business is pharmacy services.

- Strength - Prescription Drug Sales

  Rite Aid operates retail drugstores in the US. Its product class includes prescription drugs, Over-the-counter (OTC) medications and personal care, health and beauty aids and general merchandise and others. The company leverages its prescription drugs to enhance its business operations. For the FY 2014, the company generated 68.8% of its revenue from prescription drugs as compared to 67.9% in FY2013. Increased revenues from prescription drugs had favorable impact on total sales of the company. Rite Aid's total revenue for the FY 2014 was US$26,528.37 million as compared to US$25,526.41 million in FY 2013. It reported an operating income of US$820.63 million in FY 2014 as compared to US$658.82 million in 2013. It posted a net income of US$2,109.17 million in FY2014 as compared to US$249.41 million in 2013.

- Weakness - Violation of Federal Tobacco Laws and Regulation

  FDA warning letters could have a negative impact on the corporate image of the company, which could affect its profitability. In 2015, the US FDA issued Warning Letter to Rite Aid regarding tobacco retailer inspection violation. In January 2015, inspector representing the US FDA completed several inspection of the establishment at Washington Street, Charleston, West Virginia; Detroit, Michigan; Columbia, Pennsylvania; and Bridgeport, West Virginia. During this inspection it has been observed that the employees at Rite Aid violated rules by selling cigarettes to a minor and failed to check identification to verify purchaser's age.

- Weakness - Highly leveraged

According to the SEC's 10-k annual report, as of February 26, 2011 Rite-Aid has $6.2 billion of outstanding indebtedness and stockholders' deficit of $2.2 billion. The company's earnings were insufficient to cover fixed charges and preferred stock dividends for fiscal 2011, 2010, 2009, 2008 and 2007 by $564.8 million, $498.4 million, $2.6 billion, $340.6 million and $50.8 million, respectively. This indebtedness could limit the available cash flow from operations to service this debt and potentially hinder Rite-Aid's ability to service debt or obtain additional financing in the future. Moreover this will continue to restrict operations moving forward leaving the company at a competitive disadvantage, less flexible, and more vulnerable to economic conditions than other competitors with less indebtedness.

- Weakness - Dependence on a Single Wholesaler

The company's overwhelming dependence on a single wholesaler for all its branded and generic is harmful for the company. Failure to obtain required products and high dependence on sole supplier could adversely impact its ability to offer sufficient quantities of the product, which in turn would affect on Rite Aid's business operations. Rite aid purchases all its branded and generic drugs from McKesson. Any significant disruption in its relationship with McKesson could make it difficult for the company to continue to operate its business. McKesson also acts as a wholesaler for drugs purchased from ultimate manufacturers worldwide. Any disruption in the supply of a given drug could adversely impact

McKesson's ability to fulfill Rite Aid’s requirements, which could adversely affect the company.

D) Opportunities/ Threats:

- Opportunity - Rising Healthcare Expenditure in the US

  Rising healthcare expenditure provides significant opportunities to the company in generating higher revenue. The Organization for Economic Cooperation and Development (OECD) countries are set to triple spending on healthcare to over US$10 trillion by 2020, which accounts for 16% of gross domestic product (GDP) on average. Healthcare spending in most European Union countries is growing faster than their GDP. According to the US government’s Center for Medicare and Medicaid Services (CMS), healthcare expenditure in the country rose recently 6.8% to surpass US$2 trillion and represented 16% of the country’s GDP. According to the Congressional Budget Office, if the growth in healthcare spending continues at its current pace, CMS spending and private health costs will increase from the current 16% of GDP to 25% in 2025. The increase in cost is due to increased demand amid aging population and changes in lifestyle. The company can utilize its innovative product candidates to capture this increase in health care spend for higher revenue growth.

- Threat - Competitive Pressures

  Rite Aid operates into highly competitive environment of pharmaceuticals retailing. The retail pharmacy chains face extreme competition from local, regional and national companies. Rising competition in the pharmacy retail industry could affect the business of the company. Rite Aid competes with retail drugstore chains, supermarkets, independently owned drugstores, mass merchandisers, dollar stores, discount stores, and mail order pharmacies. The factors leading to competition are store location and convenient access, customer service, product selection and price. The competition for the company will increase due to the increasing consolidation in the drugstore industry, rising promotional activities to increase prescription sales and the marketing of generic drugs on a large basis by supermarkets and mass merchandisers. In this scenario, Rite Aid may find difficulties to maintain its business against the competitors with superior resources and higher capabilities.

- Threat - Governmental Regulations

  Pharmaceutical business is affected by federal, state and local government laws, regulations and administrative practices. Every company must comply with numerous provisions regulating health and safety, equal employment opportunity, minimum wage and licensing for the sale of drugs, alcoholic beverages, tobacco and other products. In addition to this, the marketing regulations differ in different geographies with different conditions. Any change of laws over a period of time or any breach of law may lead to temporary delay or permanent restriction in the commercialization of the drug. It may also result into legal proceedings and penalties for the company, which would affect the financial position of the company.

E) Target stand-alone valuation:

1) *Refer to Appendix A-E*

2) Key Forecast Assumptions:

The assumptions for revenue growth is based on historical revenue growth rates from 2011 to 2015. We chose to use 3.9% as the revenue growth rate for future projections due to the fact that Rite-Aid experienced non-recurring expenses and was especially affected by outstanding indebtedness and stockholder’s deficit from 2011-2013. To project direct operating expenses, we calculated historical operating expenses from the past 5 years as a percent of revenues. For our 2016-2020 projections, we believed that operating expenses would stay relatively close to 71.4% of revenues as it was in 2015. The operating expenses have been historically close to this percentage over the past five years as well. General administrative expenses and capital expenditures were calculated and projected in a similar manner as a percent of revenues. Additionally, we used the industry growth rate as the terminal growth rate to calculate the terminal value of the company.

For our Net Working Capital Schedule, we used data calculated for 2015 to make projections for the next 5 years. Accounts Receivable was calculated using the formula "365/(Sales/AR)", Inventory Days with "365/(COGS/Inventory)" and Accounts Payable Days projections were calculated using the formula "365/(COGS/AP)". Both Accrued Liabilities and Other Current Assets line items were calculated as a percent of revenues and projections were made using the percentages from 2015.

In order to calculate the WACC, we referred to the U.S. Treasury Bill rates to find the Risk Free rate. We calculated the Beta by finding the Rite-Aid and the S&P 500's Adjusted Closing price from the last 3 years and used the "SLOPE" function on excel to run the linear regression. In addition, the cost of debt was found in reference to the YTM of 5-year bonds. Lastly, We assumed a 38% tax rate taking into consideration the company's tax bracket.

III.Acquisition plan

A) Strategy

In comparison to remaining independent and holding only 10.3% of the total drug store market share, this acquisition would allow Rite-Aid to join with Walgreen's which holds a 31% of the total drug store market share and hold 41.3% of the pharmacy market share. Rite-Aid benefitted from this deal, with Rite-Aid shareholders holding roughly a 35% premium and receiving $9 a share which is a substantial gain if they purchased shares before the announcement in November, 2015. Being acquired by

Walgreen's would also permit Rite-Aid to remain a notable figure in the pharmaceutical industry.

Walgreen's is a desirable partner for Rite-Aid since the combination of both companies stores creates roughly 12,000 stores in total. With the combination with Walgreen's 8,000 stores, the ultimate mission of Rite-Aid in improving the health and wellness in its communities through engaging experiences in providing its customers with the best products, services, and advice in meeting their needs will be easier to achieve as well as expand into new communities. It is also beneficial for Rite-Aid since this acquisition could bring new and exciting capabilities that will aid Rite-Aid in achieving its mission.

B) Goals and Synergies

As a merged entity, Walgreens Boots Alliance and Rite Aid would be able to compete with CVS for more market share. On average, the two companies will have 70% more retail stores than CVS. The marriage would result in higher percentage of sales for both companies and it would create value for shareholders. Rite Aid could benefit from this merger by having more supplier and wholesalers who can provide them with their branded and generic products, especially because they are highly dependent on one wholesaler which is risky. Another synergy that will result from the merger is the cutting of supply chain costs and overhead items. Overall, Walgreens has valued the synergies at $1 billion, most of which come from the surge in revenue. With Rite Aid's pharmacy benefit managers (PBMs), the long-term synergy is having this service expand into all stores nationwide, which can attract more customers and result in higher sales volume. Additionally, both companies will strive to include more in-store clinics that provide health screenings and flu shots. These clinics would allow them to compete better with CVS. With access to new resources, both companies will be able to better serve their customers' health needs by providing more choices and better access to everyday reliable products and services.

C) Resource and Capability evaluation

Walgreens Boots Alliance is more than capable of completing this acquisition, even if the offer made back in October, 2015 was an all cash deal of $9.4 billion at 9 dollars per share as well as assuming all of Rite-Aids' debt, for a grand total of $17.2 billion. Walgreens plans on financing this transaction by using a combination of debt on hand and cash.

Standley, the CEO of Rite-Aid defended his golden parachute of $25 million, along with other executive and board members. He stated that Rite-Aid would become a wholly owned subsidiary of Walgreens, and that it is up to their integration team's discretion about what happens to the affected managers of Walgreens. Rite-Aid store managers don't have much to lose from this acquisition. Using the Duane Reade experience, Walgreens' used a lot of merchandising ideas and included these ideas companywide. It has kept the Duane Reade "banner" and will likely keep Rite-Aid's also. This deal will most likely not have an impact on the store employees and their respective local stores, and in the possibility of cannibalization becoming an issue, the FTC has the power to shut down 1,000 stores on the terms of the merger agreement.

The only affected party would be the higher-paid workers in corporate headquarters. There would be pressure on them to perform well enough to maintain their position and prove their value to the new entity that will soon take on CVS. However, Walgreen's has made clear that they hope to successfully retain all Rite-Aid employees and find each and every one of them a valuable position in the combined entity.

D) Purchase (offer) price estimate

Walgreens should at most pay $10.84 per share and at least $8.06 per share to acquire Rite Aid. This makes $9 per share a fair offer to acquire the pharmaceutical company. Potential sources of value are realized synergies over time. It is said that once combined, the merged company will save over $1 billion in expenses.

Capital Budget	Rite Aid				
(in thousands)					
Period	0	1	2	3	4
Year	2016	2017	2018	2019	2020
Sales Revenue	$26,528,400,000.00	$28,650,672,000.00	$30,942,725,760.00	$33,418,143,820.80	$36,091,595,326.46
VC Cost	17,243,460,000.00	18,622,936,800.00	20,112,771,744.00	21,721,793,483.52	23,459,536,962.20
Depreciation	298,496.98	382,076.13	489,057.45	625,993.53	801,271.72
Interest Expense	325,822.00	278,006.90	355,848.83	455,486.50	583,022.72
EBIT	9,284,315,681.02	10,027,075,116.97	10,829,109,109.72	11,695,268,857.25	12,630,674,069.82
Taxes	2,445,488,750.38	2,641,131,585.81	2,852,387,339.50	3,080,533,817.00	3,326,919,549.99
Net Income	6,838,826,930.64	7,385,943,531.16	7,976,721,770.22	8,614,735,040.25	9,303,754,519.83
Plus Depreciation	298,496.98	382,076.13	489,057.45	625,993.53	801,271.72
Cash Flow	6,839,125,427.62	7,386,325,607.29	7,977,210,827.67	8,615,361,033.78	9,304,555,791.55
Required Addition to Equity	6,839,125,427.62	7,386,325,607.29	7,977,210,827.67	8,615,361,033.78	9,304,555,791.55
Available CF	-	-	-	-	-
Expected Terminal Value					9,200,000.00
Free Cash Flows	$0.00	$0.00	$0.00	$0.00	$9,200,000.00
Present Value	$0.00	$0.00	$0.00	$0.00	$25,119,712.35
Total Present Value					$25,119,712.35
Max Total Offer	$11,341,390,037.24				
Maximum Offer Price Per Share	$10.84				
Premuim for Stock Price	$2.78				
Premium for Rite Aid	48%				
Premium for Walgreens	52%				
Premuim Rite Aid	$1.34				
Premuim Walgreens	$1.45				

E) Offer composition

Walgreens Boots Alliance had their offer composition of cash only because they believe that it is the most beneficial way to acquire Rite Aid. This is the best offer composition for Walgreens because it allows shareholders (especially dominant shareholders) to keep their ownership of their own company. If they chose to use common stock to acquire Rite Aid, they would dilute their ownership. Additionally, the cash offer is a set purchase price which is better for both parties because they would not have to account for any fluctuation in the stock price. But the use of cash as the offer composition requires the target's shareholders to pay capital gains taxes on the sale of their stock. Because they want to maintain ownership over their stock, an all cash offer composition is a good way for them to structure this deal.

F) Financing plan

Walgreens Boots Alliance expects to finance the transaction through a combination of existing cash, assumption of existing Rite Aid debt and issuance of new debt. In 2015, Walgreens had cash and cash equivalents $3 billion, which is not enough cash to finance their deal. Also, their outstanding debt, long-term and short-term, totals about $14.4 billion. For this deal, they need to issue more debt to finance the $9.4 billion dollars. Walgreens does not want to dilute any of their ownership from their current stockholders, so they have chosen to base their offer in all cash, which requires them to take on more debt.

G) Integration

After both Walgreen's and Rite-Aid agree on the terms set for the acquisition, the next step would be to integrate them together in order to achieve the goals and synergies. In order to integrate successfully and smoothly, both companies need to be transparent in their working conditions and what the employees are used to. The plan to integrate should be crafted when terms have been set, and should be planned by Walgreen's. However, Rite-Aid should also create a plan for integration. The integration should employ a Decision Management Office that will focus primarily on a smooth integration. The leaders of this integration should focus on leading the groups that are a part of the integration process on the decisions that will ultimately impact the value of the merging companies.

The biggest issue would be figuring out how to mesh the two companies' cultures together. Since each company has their own specific culture that defines the company and how it does things, a goal of the integration team would be to figure out how to come to a compromise between the two cultures or create the culture they would want to see emerge from the acquisition. After the type of culture desired is created, upper management should actively manage the culture in order to ensure that it is one that fits the new entity of Walgreen's and Rite-Aid. Another issue would be the retention and cuts of employees. Would the current employees of either company reflect the new culture well? Or not? Would the employees of Rite-Aid enjoy working with Walgreen's? If not, upper management would have to figure out whether to cut them out or have them train again in order to be essential to the emerging entity from this acquisition. If the solution to these unneeded employees is to fire them, their severance packages should be carefully adjusted to avoid any legal issues. Employment is a major issue in terms of integration because it can ultimately affect everyone in the company. For example, if an upper-tier manager of Rite-Aid was replaced with one from Walgreen's and the chain of command doesn't get along or work well with the new manager, there could be a loss of efficiency or even the employees under that new manager. Another issue regarding integration would be finishing in time. The future projections that were produced may not be realized and this acquisition could be a complete failure if not executed promptly and properly.

IV.Appendix

A) Baseline Levels:

Input Data			
Premerger Data			
Targets Beta	1.852	Debt to Equity Ratio	0.66
Target's debt ratio	11.94	Interest Expense as % of debt	4%
Targets 's tax rate	38.00%		
Shares Outstanding	1,046,000,000		
Current Price Per Share	$8.06		
Target's Market Value	8,430,760,000		
Depreciation 2015	448,387,000		
Dep as % of Assets	3.37%		
Cash on Hand CBS	3,000,000,000		
Post Merger Data			
Debt to Equity Ratio	0.4754	Sales Growth With Merger	8.0%
Tax Rate After Merger	26.34%	2015 Sales	26,528,400,000
Initial Assets	19,660,000,000	Sales Growth Without Merger	4%
Market Data			
Risk-Free rate	1.74%	Operating Expenses as % of Sales	65.0%
Market Risk Premium	5.27%	Operating Expense as % of Sales without Merger	71%
Premerger beta	1.852	Unleverd Beta	1.312884922
Post Merger Beta		Discount Rate	17.24%
Levered Beta		K(AMC)	2.94
		Relever Beta	3.24702699
Wacc	7.56%		
Cost of Equity	11.50%		
Weight of Equity	59.40%		
Cost of Debt	1.80%		
Weight of Debt	40.60%		

B) Stand-alone valuation/without merger

Capital Budget	Rite Aid				
(in thousands)					
Period	0	1	2	3	4
Year	2016	2017	2018	2019	2020
Sales Revenue	$26,528,400,000.00	$27,563,007,600.00	$28,637,964,896.40	$29,754,845,527.36	$30,915,284,502.93
VC Cost	18,941,277,600.00	19,679,987,426.40	20,447,506,936.03	21,244,959,706.53	22,073,513,135.09
Depreciation	893,449,983.60	928,294,532.96	964,498,019.75	1,002,113,442.52	1,041,195,866.77
EBIT	6,693,672,416.40	6,954,725,640.64	7,225,959,940.62	7,507,772,378.31	7,800,575,501.06
Taxes	2,543,595,518.23	2,642,795,743.44	2,745,864,777.44	2,852,953,503.76	2,964,218,690.40
Net Income	4,150,076,898.17	4,311,929,897.20	4,480,095,163.19	4,654,818,874.55	4,836,356,810.66
Plus Depreciation	893,449,983.60	928,294,532.96	964,498,019.75	1,002,113,442.52	1,041,195,866.77
Cash Flow	5,043,526,881.77	5,240,224,430.16	5,444,593,182.93	5,656,932,317.07	5,877,552,677.43
Required Addition to Equity	5,043,526,881.77	5,240,224,430.16	5,444,593,182.93	5,656,932,317.07	5,877,552,677.43
Available CF	-	-	-	-	-
Expected Terminal Value					8,430,760.00
Free Cash Flows	$0.00	$0.00	$0.00	$0.00	$8,430,760.00
Present Value	$0.00	$0.00	$0.00	$0.00	$23,019,376.75
Total Present Value					$23,019,376.75
Max Total Offer	$10,393,101,898.95				
Maximum Offer Price Per Share	$9.94				
Premuim for Stock Price	$9.94				
Premium for Rite Aid	35%				
Premium for Walgreens	65%				
Premuim Rite Aid	$3.48				
Premium Walgreens	$6.46				

C) Post-merger valuation

Capital Budget	Rite Aid				
(in thousands)					
Period	0	1	2	3	4
Year	2016	2017	2018	2019	2020
Sales Revenue	$26,528,400,000.00	$28,650,672,000.00	$30,942,725,760.00	$33,418,143,820.80	$36,091,595,326.46
VC Cost	17,243,460,000.00	18,622,936,800.00	20,112,771,744.00	21,721,793,483.52	23,459,536,962.20
Depreciation	298,496.98	382,076.13	489,057.45	625,993.53	801,271.72
Interest Expense	325,822.00	278,006.90	355,848.83	455,486.50	583,022.72
EBIT	9,284,315,681.02	10,027,075,116.97	10,829,109,109.72	11,695,268,857.25	12,630,674,069.82
Taxes	2,445,488,750.38	2,641,131,585.81	2,852,387,339.50	3,080,533,817.00	3,326,919,549.99
Net Income	6,838,826,930.64	7,385,943,531.16	7,976,721,770.22	8,614,735,040.25	9,303,754,519.83
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