Kroger Albertsons Deal

Introduction

The Kroger Company [KR : NYSE], one of the largest supermarket chains in the United States, has announced the acquisition of grocery store Albertsons [ACI : NYSE] in an attempt to expand its market share with hopes of reaching nearly 5000 stores across 48 states. The deal, which is valued at $24.6bn, is contingent on the assumption of nearly $4.7bn of Albertsons' net debt. Albertsons shareholders will be payed $4bn as a special cash dividend. The merger would enable Kroger to reach 85m households across the continental United States.

Following the merger, Albertsons and Kroger manage 4,996 stores, 66 distribution centers, 52 manufacturing facilities, 3,972 pharmacies, and 2,015 fuel outlets with a combined workforce of more than 710,000 employees. The arrangement was unanimously accepted by the boards of both companies, but it will undoubtedly need to pass strict regulatory review. There is however, a strong confidence in the deal's ability to get regulatory approval, due to Walmart's existence as a larger corporation.

About Kroger

The Kroger Company is an American retail company headquartered in Cincinatti, Ohio, with a market share approaching 10% of the supermarket industry in the US. It provides a plethora of services ranging from service goods which accounted for 75% of the total revenue to pharmaceuticals for 9%, fuel stations for 10.8% and alternative income streams such as their florist department for 5.2%. A survey from 2018, showed that Kroger's target audience included one-third of American consumers aged 30 to 49 which shopped at Kroger grocery stores as their premiere destination. On the other hand, about one-fourth of people between the ages of 18 to 29, and 50 to 64 respectively utilized Kroger as their flagship supermarket regularly.

The Kroger Company, which had a market value of c. $32bn, generated an annual revenue of $138bn in the fiscal year 2022, which was a 4% increase on 2021. This was done through its several revenue streams including non perishable goods accounting for $69.7bn, perishable goods for $34bn, fuel for $14.7bn, pharmaceutical products for $12.4bn and $7.2bn in alternative streams, which resulted in a profit margin of 1.7%.

Due to consumers' increased demand for groceries and other household necessities at the expense of discretionary items due to inflation, Kroger increased its annual sales and profit. Kroger benefited from demand for its less expensive in-house commodities like cheese and meats as economic turbulence tends to favour spending on food and other necessities among cash-strapped consumers. Sales have increased recently at rivals Walmart Inc [WMT : NYSE] and Target Corporation [TGT : NYSE] as well. However, the big box retailers' greater reliance on clothing and other trend reliant discretionary goods has resulted in inflated inventory, more discounts, and a decline in sales and earnings. The grocery-focused Kroger announced a second-quarter attributable profit increase of 57% to $731m.

About Albertsons

Albertsons Companies Inc is one of the most prominent supermarket chains and drug stores in the United States. Albertsons has 2200 stores, 22 distribution centers and 19 manufacturing plants with coverage in 34 states. Thanks to an employee headcount of 290,000 they have been able to achieve a sales market share of 5.7% in the US supermarket industry. The company was founded in 1939 by Joseph Albertson and is headquartered in Boise, Idaho. Albertsons is the third largest grocery retailer in North America, sitting only behind Walmart and Kroger.

Albertsons, whose market cap is c. $11.3bn, generated a revenue of $75.3bn in the fiscal year 2022, which was a 9.3% increase on 2021. The financial success of Albertsons was accomplished as the country was dealing with a pandemic on a global scale. As of April 23, the corporation had contributed by giving out 3.1 million doses of the COVID-19 vaccination through its pharmacy employees. All of the retailer's pharmacy locations offered vaccinations, and business increased as a result of the hiring of 1,000 new staff and 2,000 pharmacy technicians. Additionally, the pandemic's effects resulted in higher revenue from digital sales, which grew by 258% for the fiscal year 2020 and by 282% in the fourth quarter. Every quarter of the year, Albertsons saw a surge in digital sales of more than 200%. Sales of curbside collection increased by over 1,000% in the final quarter and by 865% overall.

During the quarter, 343 new curbside pickup locations were introduced by Albertsons, and 1,420 shops provided the service. Albertsons set a goal to expand the programme to about 2,000 stores by the end of the fiscal year 2021, exceeding its prior goal of over 1,800 locations with 98% of its stores offering the service. The aforementioned plan was put into action, which resulted in an increase in revenue of 9.3% in the fiscal year 2022. FreshPass, an improved rewards program introduced by the grocery tycoon in 2021, helped them boost sales by over 10% in the previous year. The Albertsons app's optional subscription service served as its foundation. It was available for $99 a year and included unlimited free delivery on purchases of $30 or more, free curbside pickup and free two-hour supermarket delivery. List builders, a pay-from-app capability, and the combination of digital wallet and app coupons were among the key selling points.

Industry Analysis

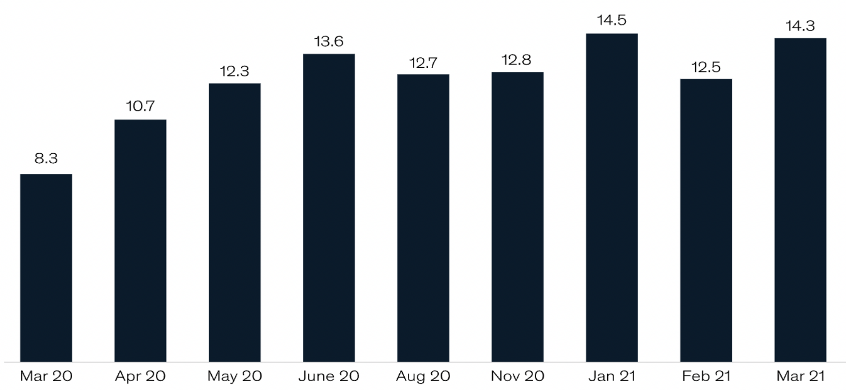
The food and retail services industry in the United States reached just over $6.2tn in sales in 2020, increasing for the eleventh year in a row. Sales at supermarkets and other grocery stores are projected to reach $742bn in 2020, accounting for approximately 86% of the market for food and drink in the United States. Walmart, the largest US player in the industry, had 4,742 stores open as of 2022, and its U.S. business had a revenue of $573bn.

When buying food and items for daily usage, American consumers typically prefer supermarkets to other distribution methods. Although physical stores continue to be the primary sales channel for groceries, the digital sector is predicted to increase significantly over the next few years. Online grocery shopping sales in the United States are anticipated to reach $190bn by 2024, thanks in part to increased convenience and better delivery options. Consumers can now buy groceries online through many platforms and channels, including those provided by traditional food retailers such as Kroger, Albertsons and Walmart. Despite growing competition, Walmart still captures around 47% of grocery delivery and pickup sales. In leading countries, online grocery could make up 18 to 30 percent of the food-at-home market by 2030. Scheduled delivery (with the promise of same-day service) will still account for the majority of this share, while instant delivery (defined as delivery on demand, typically with a 15 to o 30 minute lead time) could reach between 3% to 7% of the total food-at-home market in leading countries.

Due to the presence of numerous international and regional firms, the US supermarket industry is fragmented. To grow their customer base and brand loyalty, these companies are conducting significant acquisition and promotional campaigns. Additionally, these firms are utilising cutting-edge innovations like blockchain and AI to improve client experiences and streamline their supply chain operations. For example, in 2021, Sainsbury's, a grocery shop in the United Kingdom, and Amazon collaborated to test a "simply walk out" store where customers could purchase groceries without having to scan products or wait in checkout lines. Walmart revealed a new technology named Alphabot for its supermarket division in January 2020. In an effort to increase its presence, the platform allowed customers to pick, pack, and deliver online grocery orders more quickly, which helped cement it as America's largest grocer. Some of the key players operating in the grocery retail market include: Walmart, Costco [COST : NASDAQ], 7-ELEVEN [SVNDY : OTCMKTS], Amazon [AMZN : NASDAQ], Kroger, Target, and ALDI.

The COVID-19 pandemic impacted the supermarket industry heavily in the United States. During the pandemic, grocery stores significantly increased their "share of stomach" because more people in the United States had to live, work, and learn at home. In 2020, the American supermarket industry saw growth of about 12%, countering considerable declines in food consumed outside the home in a sector that has historically experienced growth of 1%-2% annually. Customers chose to visit grocery stores other than their usual major locations during the early disruption of March and April 2020, which was defined by initial lockdowns and the closure of all unnecessary companies. This trend marked a significant departure from traditional purchase motivators including pricing, service, and in-store experience. It was primarily impacted by proximity, store cleanliness, health, safety, and in-stock products. Behavior changes kept moulding a changing sector as the pandemic came to be seen as a long temr crisis. Online penetration accelerated five years in just a few months. E-commerce was still a minor market with some segments in North America as of late 2019, mostly usedbt younger consumers. By late spring of 2020, e-commerce accounted for 10 to 15% of all sales, with some locations surpassing 20%.

Estimated e-commerce penetration in grocery, %



Kroger Co. was the second largest grocery chain in terms of revenue in the US in 2020. The business generated almost twice as much revenue as Albertsons Companies, which came in third with over $70bn. In 2020, Kroger was the market leader in terms of the number of outlets with slightly under 3,000 stores across the country. Furthermore, lookinf at food spending total sales, Kroger represent15.6% of food spending in the US, having as only bi gcompetitor Walmart, with a share of 20.9%.

Deal structure

On the 14th of October 2022, Kroger announced it would acquire Albertsons Companies in what appears to be one of the largest deals ever in the food market. The terms of the merger agreement have already been unanimously approved by the board of directors of both firms.

Kroger will acquire all the outstanding shares of Albertsons Companies, common and preferred stock - on an as converted basis - for a price of $34.10 per share. This, gives Albertsons an enterprise value of $24.5bn, assuming $4.7bn of Albertsons net debt. The purchase price upon which both firms have agreed represents a premium of approximately 33% to the closing price of Albertsons' shares on the 12th of October, and 29.7% to the 30-day volume-weighted average price.

Subject to discussions with antitrust authorities, a possible store divestiture process is being studied. The cash component of the $34.10 per share offer by Kroger would thus be reduced by the per share value of a newly created public company, which would be called "SpinCo" that Albertsons is prepared to spin off. Also, as part of the transaction, Albertsons will pay a special cash dividend (non-recurring distribution of Albertsons cash to its shareholders) of up to $4bn to its shareholders on the 7th of November. The cash component of the $34.10 per share consideration will thus also be reduced by the per share amount of this special cash dividend. It is today estimated that it'll stand at $6.85, and considering there are 576mn Albertsons outstanding shares, the special dividend will amount to 576m outstanding shares multiplied b y$6.85 resulting to total of $3.95bn.

The transaction is expected to close in early 2024, subject to the receipt of required regulatory clearance and other customary closing conditions, including receipt of clearance under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, which requires parties to report large transactions to both the Federal Trade Commission and the US Department of Justice Antitrust Division for antitrust review. Albertsons net profit margin as of August 31, 2022 is 2.27%, compared to the industry average of 1.5%. Its debt-to-equity ratio stands at 1.62, just over the industry average of 1.2%. Albertsons' EV ratio is 3.51, indicating the stock isn't over valued and that it's profitable to invest in the company.

Kroger expects the transaction to be accretive to earnings in the first year following close, and double digit accretive to earnings by year four. Kroger's main shareholders are investment funds such as the Vanguard Group (10.74%), BlackRock (10.10%), Berkshire Hathaway Inc. (8.40%), or State Street Corporation (5.09%). Blackrock and the Vanguard Group are also amongst Albertsons' largest shareholders.

Deal rationale

Kroger executives have provide many reasons for this merger: a broader national footprint will allow them to improve the distribution of fresh food, this greater scale will add purchasing power and improve the private label business (when manufacturers creates products that are sold exclusively by a third party under a different brand name). It's expected that retail advertising and other initiatives will also be boosted by the merger. With a customer base of approximately 85 million households, the combined company will have a massive amount of data to improve their retail loyalty programs, using Krogers' impressive data science capabilities. At a time when people are increasingly shopping for groceries and eating at home, this new company will also be better positioned to relieve inflationary pressures facing shoppers: Kroger plans to reinvest approximately half a billion dollars of cost savings from synergies to reduce prices for customers.

However, none of these synergies are sufficient to explain why Kroger would pay a 30% premium in a context of globally rising interest rates which make it much harder to finance oneself. What seems to be a better explanation, is Kroger's desperate need for more market power: it's hard to picture, but this new grocer would corner almost 20% of the food market, hitting revenues of $200bn each year thanks to its 5000 stokers and 700 000 employees. And this is only necessary when it comes to competing in the food market. These days, the biggest grocery retailer is Walmart, it controls 27% of the market, and it generated $218bn last year from food sales, or 55% of its U.S. revenue. Amazon, which acquired Whole Foods in 2017, is a smaller presence but is adding pressure on rivals as it gains market share. Incredible as it might seem, from Kroger and Albertsons' perspective, this merger is existential: if they aren't allowed to grow bigger, they risk failing since economies of scale are necessary to remain competitive against ever growing competitors lowering their prices. Investors' take on the matter, considering their reaction on capital markets, is that Kroger's acquisition of Albertsons is a sign that the firm is not convinced it would manage to keep performing well on its own, and the same can be said of Albertsons.

Another problem for Kroger and Albertsons is regulators. That's because if the merger went through, the combined Albertsons-Kroger and Walmart would control 70% or more of the market in 167 cities in the United States. In some cities, their share would even exceed 90%. This puts pressure on the Biden administration, at a time when high inflation has pushed us towards a global food security crisis. Food prices in the United States rose YOY more than 11% in September. That review, which will be handled by the FTC (Federal Trade Commission), will look at whether the deal will actually result in favorable prices for consumers. The agency will also look at whether the deal will achieve the proposed efficiencies Kroger has put forward. So what do the companies plan to do to appease regulators? Well, to address these concerns, the two grocers said they planned to sell stores to competitors, especially on the West Coast, where Krogers and Albertsons store strongly overlap. This means they could spin off up to 375 stores into the previously mentioned separate company named "SpinCo".

Market reaction

After Kroger (NYSE:KR) announced its acquisition of Albertsons on the 14th of October, the company shares closed at $43.16, down 7.3% from the previous day. The drop in stock price wiped roughly $2.5bn off the company's market capitalization. On that same day, investors also promptly sold of Albertsons stock, which fell 8.5% and closed at $26.21. Why would investors sell stock they'll soon be able to sell at a much higher price? The only possible answer is that investors aren't convinced that the deal will actually go through. In other words, investors are not ready to take on the risk of a deal break until at least early 2024, which is, according to Kroger's press release, when the deal is supposed to close.

To analysts' eyes benefits can only play out if the merger passes FTC scrutiny, and if it doesn't then it's a likely low, single-digit base business EPS growth over the next two years, and that's a good enough reason for analysts not to rise their expectations on the firm and its stock.

Q2 financial results for Kroger were strong: sales on the rise year over year, and so were net profits as the American economy expanded after the Covid pandemic. Still, another element that spooked investors was the idea of taking on debt to buy Albertsons in a context of rising interest rates, making it more expensive for Kroger to finance such a deal. Both Kroger and Albertsons have yet to publish their third quarter financial results.

Deal Advisors

Citi and Wells Fargo are serving as financial advisors and Weil, Gotshal & Manges LLP and Arnold & Porter Kaye Scholer LLP are serving as legal counsel to Kroger.

Goldman Sachs and Credit Suisse are serving as financial advisors and Jenner & Block LLP is serving as corporate legal counsel and White & Case LLP and Debevoise & Plimpton LLP are serving as antitrust legal counsel to Albertsons.

Tags: #USA #NorthAmerica #Grocery #Kroger #Albertsons #Walmart #WholeFoods #FTC