To merge or not to merge? Shareholders divided over controversial Ritchie Bros. – IAA proposed merger

Introduction

Global asset manager and disposition company Ritchie Bros. Auctioneers recently announced an amended agreement to acquire salvage-yard operator IAA, valuing the company at $5.94bn. The improved cash-and-stock offer comes after an initial bid, that included 28% less cash but more equity, was met with concerns from shareholders and a negative reaction from the market. The last offer has been unanimously approved by both companies' Boards of Directors, but still left shareholders divided. Supporting shareholders include UK investment firm Independent Franchise Partners and Starboard Value, whose $500m financing package helped finance the cash portion of the improved bid, but they face stiff opposition from Luxor Capital and Deep Field Asset Management amongst others.

About Ritchie Bros

Ritchie Bros, founded in British Columbia in 1958, is a leader in asset management and disposition technologies for industrial assets. The company's core business revolves around running auctions and managing online marketplaces, listings, and online brokerage services, through which clients, ranging from companies to governments, sell their commercial and industrial assets. In 2022, their Gross Transaction Value (GTV), i.e. the total proceeds from all items sold at auctions and online marketplaces, amounted to $6bn.

In 2022, 81% of the GTV came from straight commission contracts, in which the consignor pays a fixed, agreed-upon commission rate. The remaining 19% came from guarantee contracts, where the seller always receives a minimum amount from the auction, and inventory contracts, where Ritchie Bros itself purchases and holds used assets, in order to resell them later on.

In addition to that, Ritchie Bros provides complementary services to its clients, among which equipment financing, asset appraisals and inspections, online equipment listing, logistical services, and ancillary services such as equipment refurbishment. The company also offers customers a platform that helps them with equipment lifecycle management, part procurement through Original Equipment Manufacturers (OEM) and dealers, and gives them access to market intelligence, in order to make better decisions.

Ritchie Bros increased revenues 22% YoY in 2022 to $1.7bn, $1.1bn of which coming from services, and the remaining $683.2m coming from inventory sales. Operating Income grew 89.3% to $454m, reaching a 26.2% EBIT Margin.

About IAA

IAA, founded in 1982, provides an online marketplace where total-loss, damaged and low-value vehicles are bought and sold, mostly through auctions (IAA Timed Auctions) or direct sale at a fixed price (IAA Buy Now). Sellers include insurance companies, dealerships, fleet lease and rental car companies. Buyers head to the platform to get replacement parts and fulfill their vehicle rebuild requirements. The company moves more than 2.3m cars every year, as of 2022. IAA was first taken public in 1991, and later acquired by two Private Equity firms in 2005, which consolidated it into KAR. In 2018, it was spun off from KAR into a separate company, and listed on the NYSE again.

Approximately 2/3 of the firm's revenue is earned from buyers, who pay fees for each vehicle purchased, the amount of which is tied to the transaction value, and pay for additional services such as storage, transportation, and vehicle condition reporting. Buyers also pay a fixed fee to access the auctions. The other third of the revenue is earned from sellers and suppliers, who pay an agreed-upon fee for processing and service. The company also buys cars itself, in order to either resell them or dismantle them to sell the parts/scraps.

IAA's model is capital-light, with low capex requirements and strong operating margins. The space in which the company operates has significant barriers to entry, mainly because of the long-term relationships with insurance companies, dealerships, rental car companies and fleet lease companies. The company increased its turnover 14.2% YoY in 2022, to almost $2.1bn, with $1.7bn being service revenues and the remaining $0.4bn coming from vehicle and parts sales. Operating Profit was $417m, exhibiting a strong EBIT margin of 19.9%.

Deal Structure

The merger between Ritchie Bros and IAA will be financed through a mix of stock and cash. According to the initial offer, dating back to November 8, 2022, IAA shareholders were to receive $10 per share in cash and 0.5804 shares of Ritchie Bros. for each IAA share they own.

On January 23, the two companies announced an amendment of the merger agreement: IAA shareholders will now receive $12.80 per share in cash and 0.5252 shares of Ritchie Bros. for each share of IAA they own. This represents a change in the cash/stock financing mix from 22%/78% to 29%/71%. In addition to that, Ritchie Bros. Board of Directors announced an expected special cash dividend to the company's shareholders, amounting to $1.08 per common share. This amendment to the deal structure was mainly possible thanks to the $500m investment from Starboard, comprising of $485m in convertible preferred equity and $15m in common shares.

If the transaction were to finalize, Ritchie Bros. shareholders would end up owning 59.1% of the new company, while IAA shareholders and Starboard would own 37.2% and 3.7%, respectively.

Shareholders' Divide

Immediately after the announcement of the merger, shareholders of both companies were divided on the strategic soundness of the deal, and many activist shareholders met the decision with stiff opposition. The main opposers of the deal, on RBA's side, are Luxor Capital Group (3.6%), Janus Henderson (3.4%), Eminence Capital, and Deep Field Asset Management; Discerene, which owns a 3.6% stake in IAA, also came out against the deal.

On the opposing side of the merger, firms argue that the two companies are not a good strategic fit, and even though there could be some strategic opportunities from the merger, they do not justify the risk carried by the transaction. Furthermore, many of the opportunities brought up by Ritchie Bros' management to support the merger are not consequences of the merger and could be achieved separately.

On the supporting side, some shareholders have been promoting the deal: Starboard pushed for the merger and also made a strategic investment of $500m in RBA, and Ancora, which initially expressed concern about the operation, is now supporting it. Other supporters include Eagle Asset Management and Independent Franchise Partners.

Deal Rationale

Led by Ann Fandozzi, Ritchie Bros aims to make strategic profits from its merger with IAA. Indeed, RBA justifies paying a premium for the salvage-yard operator through cost-savings, synergies, and new revenue opportunities. The acquirers will be able to leverage IAA's real estate footprint with some of its locations that are unduplicable to expand their satellite yard strategy and improve equipment inventory agility. The integration of IAA will continue to strengthen Ritchie Bros' core operations, advancing its omnichannel platform and accelerating overall growth. As a result, according to both companies, savings are set to increase EBITDA by $110m, and growth prospects are expected to account for an EBITDA expansion of $250m to $780m. Though such predictions are often doubtful, certain shareholders by the likes of Eagle Asset Management and Independent Franchise Partners have a strong faith in Fandozzi and her ability to capitalize on significant earning potentials. A similar sentiment is held by a small majority on the other side of the merger with IAA shareholder, Ancora, restating its support of the deal as a lucrative opportunity.

However, there is an increasing tension among investors with several Ritchie Bros and IAA shareholders publicly stating their opposition to the merger. On the one hand, RBA's shareholders do not believe the premium paid for IAA is justifiable. In fact, even if the expected EBITDA assumptions take place, taxed, and capitalized they will be worth less than $900m, barely more than the premium paid. In addition, adding up the market values of both companies, Ritchie Bros' shareholders' 59% minus cash used to pay for IAA, accounts for $6.4bn which is less than the company's value today. Shareholders by the likes of Eminence Capital acknowledge the possible synergies of the merger but affirm that it would burden RBA's investors with unnecessary risk compared to the potential upside of this "public market LBO". On the other hand, IAA shareholders strictly reject the rationale and timing of the sale as highlighted in Discerene's open letter to reject the merger. Indeed, investors maintain that the cost synergies and growth opportunities can be achieved through operational improvements, which had previously been confirmed by IAA's management. Therefore, they believe in IAA's strong prospects as an independent company with the time needed to implement such developments. Lastly, reluctant shareholders were further encouraged to "destroy" the merger as current short-term pressures on IAA's valuation benefit Ritchie Bros and their second $7bn offer was not well received by a considerable number of investors.

Market reaction

When the initial $6bn cash and stock offer was announced in November, the market had a negative reaction, with Ritchie Bros. shares falling by 18%. Despite that, bullish estimates from Ritchie CEO Ann Fandozzi and positive Q4 results have since caused a recovery of the previous losses. Ritchie Bros. stock traded at around $62 per share just before the merger announcement, subsequently tumbling to $50 per share, only to recover to $64 per share on February 13th. Fandozzi estimated that $120m worth of cost savings from the merger are worth $76 per share.

After Ritchie Bros.'s improved offer, with 28% more cash and less equity, on January 23, the market had a much better reaction. Both IAA and Ritchie stock prices fell slightly, only to recover a few days later to the same level as pre-announcement. This neutral reaction indicates an improvement of market sentiment regarding the potential deal, but also highlights the shareholder divide currently dooming Ritchie Bros and IAA.

Advisors

Ritchie Bros. is advised by a consortium of advisors led by Goldman Sachs, with Guggenheim Securities, RBC Capital Markets and Evercore serving as co-financial advisors. JP Morgan is the sole advisor of IAA.

Goodwin Procter LLP, McCarthy Tétrault LLP and Skadden, Arps, Slate, Meagher & Flom LLP are the legal advisors for Ritchie Bros.. IAA's consortium of legal advisors is formed by Cooley LLP, Blake, Cassels & Graydon LLP and Latham & Watkins LLP.

The fate of the deal will be decided on March 14, when shareholders of both companies vote on the deal in special meetings.

TAGS: Ritchie Bros., M&A, IAA, deal