Albertsons

TRADITION
INVESTMENT MANAGEMENT

Albertsons-Kroger Deal Offers a Potential Premium

Price $18.46 **Dividend Buy** **September 12, 2024**

- 2.7% Yield.
- Kroger agreed to purchase Albertsons for $24.6 billion in October 2022.
- If approved, Albertsons shareholders will receive $27.25 per share, a 48.3% premium to the current stock price.
- Albertsons holds 6.4% of total grocery market share in 2023, while Kroger holds 10.1%.
- $600 million claw back provision to be paid to Albertsons if the merger does not go through, recouping its costs.

Investment Thesis

Albertsons (ACI) is a US grocery chain that operates 2,269 stores across 20 banner brands including Safeway, Albertsons, Acme, and Shaw's, and 3 private label brands that earn more than $1 billion each.

Same store sales increased by 1.4% year over year in the quarter ended June 2024, with a minor expansion of gross margins to 28.42%. According to Numerator, Albertsons holds 6.4% of total grocery spending in 2023.

In October 2022 Kroger, who holds 10.1% of grocery spending, agreed to purchase Albertsons for $24.6 billion adding to Kroger's 35 state 2,750 store footprint. Various state governments and the FTC have come out against the merger, stating that it creates an unfair monopoly on grocery pricing. The status of the case remains up in the air.

We feel that there is still a chance that the merger will go through, despite Albertsons trading at a substantial discount. If the merger does go through, Albertsons shareholders can expect $27.25 in the all-cash deal, a substantial premium of 48.3% to the current stock price. If the merger does not go through, we feel that there is little downside given the short-term prospects for Albertsons are still solid, with a 2.7% dividend yield, a $600 million breakup fee to be collected, and resilient consumer-staples earnings profile.

Estimated Fair Value

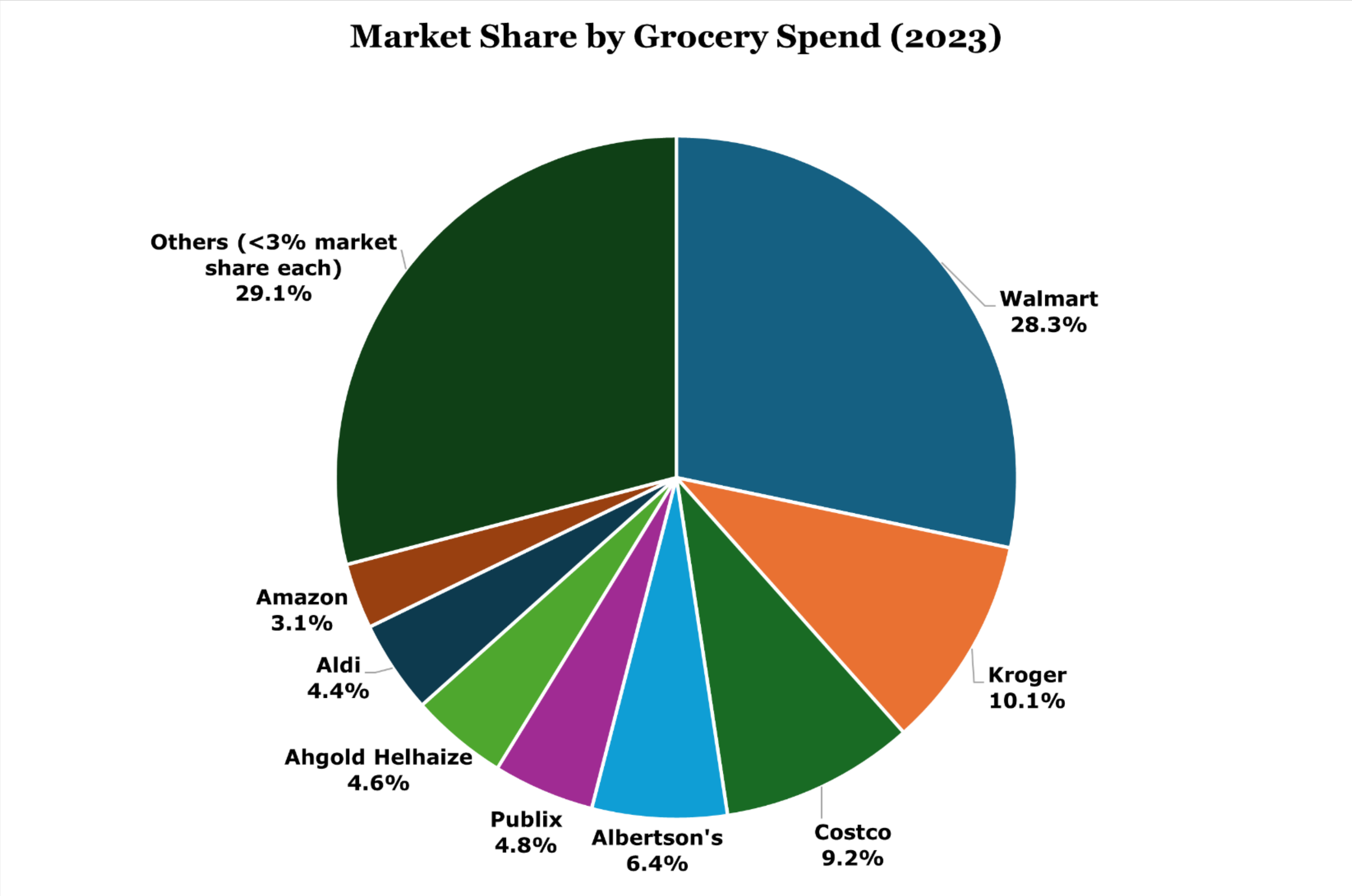
EFV (Estimated Fair Value) = EFY25 EPS (Earnings Per Share) times P/E (Price/EPS)

EFV = E25 EPS X P/E = $2.60 X 10.5 = $27.30

Merger Price: $27.25 all-cash to Albertsons shareholders

	E2024	E2025	E2026
Price-to-Sales	0.1	0.1	0.1
Price-to-Earnings	7.6	7.6	7.2

The Merger



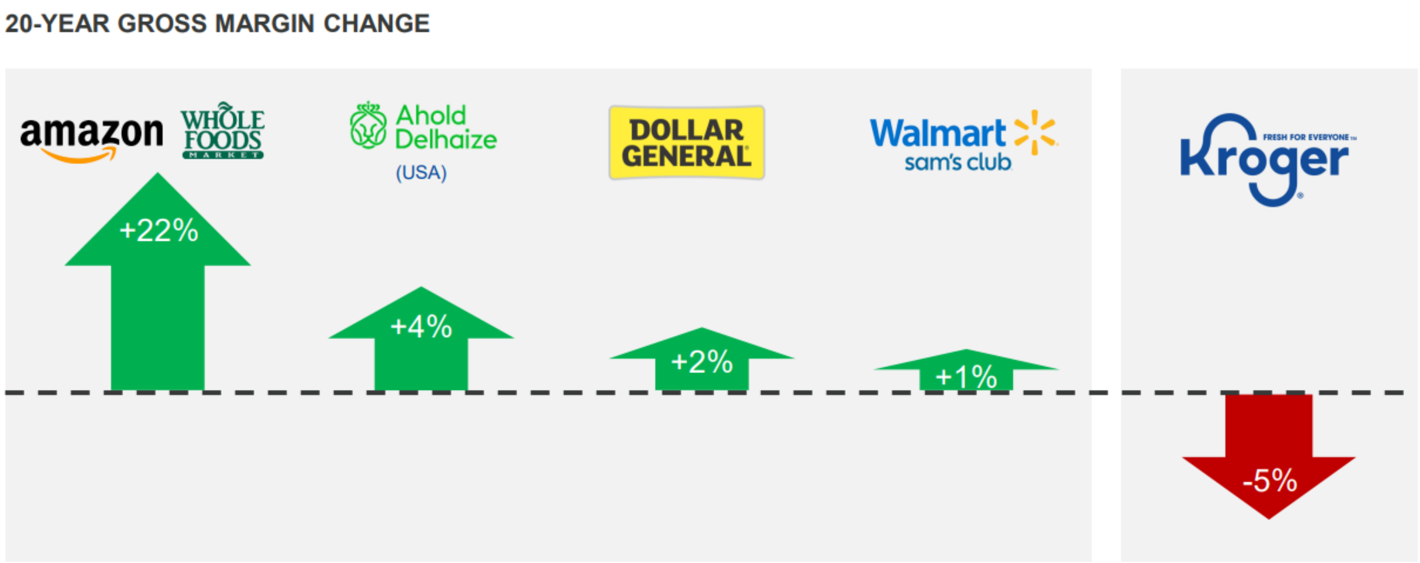
Source: Numerator. Grocers by Dollar Share. Walmart includes Sam's Club. Amazon includes Whole Foods.

In accordance with the plan, Albertsons would sell off 413 of its stores (18.2% of them), 8 distribution centers (36% of them), and 2 offices across 17 states. Kroger, for its part, would divest 163 stores. All these divestitures are concentrated in areas like Oregon, in which Albertsons and Kroger's combined entity would make up more than 50% of estimated local market share. According to ABC news, the combined entity would have a market share of around 13%. This is still a reach to Walmart's top spot, but a substantial move in the right direction.

In our view, this combination would move the needle to allow the combined entity to compete more broadly with Walmart and Costco on price. On "day one" of the merger being approved, the new combined entity would cut prices by a promised $1 billion. In our view this gap will largely come from price equalizing actions, Albertsons grocery prices are 10-12% higher than Kroger.

However, we also believe that this price cutting strategy could begin to close the grocery spend gap between the new entity and Walmart or Costco. Grocer margins are not high, with the average grocery store earning between 1-3% net income margin.

The first problem is grocery pure players, like Kroger or Albertsons, are generally price takers due to the low-margin and commoditized nature of the business. While there is some room for price movement due to food being price inelastic, the actual scope of higher prices to enhance margins outside of extraordinary events is incredibly limited for grocers.



Kroger Investor Relations

The next is that Walmart, Amazon, Costco, and others have a distinct ability to eat losses on groceries during high-price periods and continue to offer steep discounting long-after it would be uneconomical for a pure-player. A more diverse revenue stream often carries higher margins as companies can make up for incredibly limited grocery margins by selling other things. The only way for Albertsons and Kroger to compete is through scale, which would be accomplished by merging the two entities, or through a large expansion of private-label offerings which both are pursuing independent of the merger.

Antitrust Case

The FTC's case hinges on the idea that there would be unfair competition among supermarkets within the United States. While the FTC does acknowledge that Walmart, Costco, and Amazon compete in the grocery marketplace, they should not be classified as competitors. According to the FTC, under the "Brown Shoe" test supermarkets are considered supermarkets because of their wide selection of groceries, household items, and include services like deli counters, bakeries, and pharmacies which are ‘distinctly different’ to the models of Costco, Amazon, and Walmart. Thus, the combination of Albertsons and Kroger would lead to unfair pricing power. As previously mentioned, grocers are generally price takers, and the combined entity would cut prices to price equalize between the two brands.

Walmart earns just shy of 60% of its revenue from groceries and has 28.3% of the American grocery spend. Both Costco and Walmart operate a pharmacy, deli counter, and bakery in most of their stores. Though we do feel that the FTC can be met in the middle by Kroger and Albertsons, perhaps growing the number of markets it chooses to divest stores in or choosing another divestiture partner, more favorable than C&S which the FTC believes is not capable of managing the massive 500+ store divestiture.

Risk

The last major merger involving Albertsons, the acquisition of Safeway in 2015, was rife with controversy. In a similar agreement, Albertsons spun out several stores in low-competition markets to a separate chain which went bankrupt within 8 months allowing Albertsons to reacquire them for a discount and maintain its concentration. This left a bad taste in the mouth of the FTC, and state-level regulators.

The opportunity costs of the merger are high. Over the last 2 years Albertsons has spent $329.4 million in costs. If the merger fails, Alberton’s will claw this back with a $600 million cancellation clause. However, Albertsons did state in court proceedings with the FTC that it would be able to continue to operate as normal for 2-4 years but would have to shift its cost structure, which may include exiting markets. While this may have been played up for court, Alberton’s has high leverage compared to peers, with 485.5% debt to equity and a coverage ratio of just 4.4x.

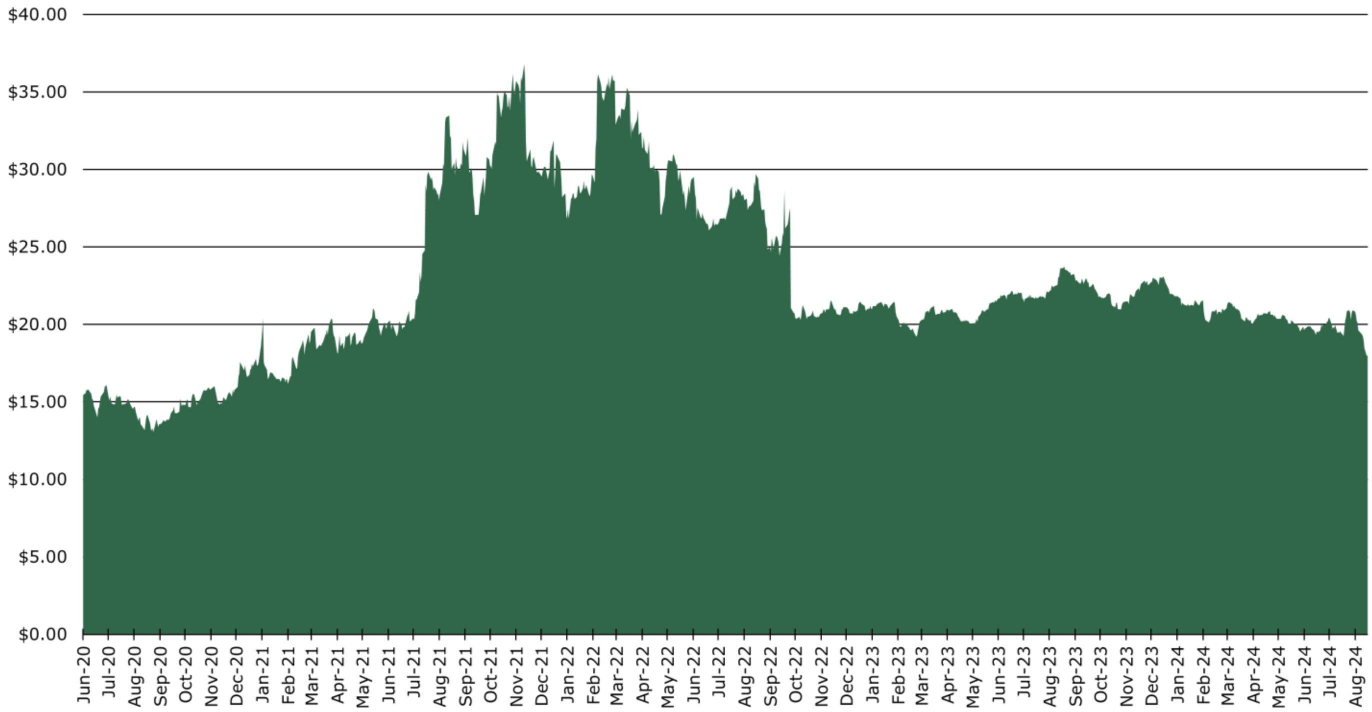
Conclusion

Despite the ongoing anti-trust case, we feel that there is still a strong case for the merger to go through, which would provide a substantial premium to investors. In the event it doesn’t go through, there is very little downside to owning Albertsons given its 2.7% yield and strong consumer staples earnings profile in our opinion.

Peer Comparisons

	Albertsons (ACI)	Kroger (KR)	Sprouts Farmers Market (SFM)	Casey's General Stores (CASY)	SpartanNash (SPTN)
Price-to-Earnings	7.64	11.78	30.30	26.27	10.71
Price-to-Sales (TTM)	0.13	0.25	1.43	0.92	0.08
EV-to-EBITDA (FWD)	5.98	6.94	19.53	13.06	6.14
Net Income Margin	1.41%	1.43%	4.52%	3.40%	0.48%
Dividend Yield	2.66%	2.45%	-	0.53%	3.99%

Albertsons (ACI)



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