PressAcademia
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IFC
ISBN 978-605-06192-5-6

PressAcademia Procedia
YEAR 2022 VOLUME 16

11th Istanbul Finance Congress (IFC), December 15, Istanbul, Turkey

DID WALGREENS AND RITE AID BENEFIT FROM THEIR 2017 DEAL?

DOI: 10.17261/Pressacademia.2023.1655
PAP- V.16-2023(1)-p.1-6

Khamis M. Bilbeisi[1] and C. R. Narayanaswamy[2]
[1]Clayton State University, College of Business, Morrow, Georgia, USA.
khamisbilbeisi@clayton.edu , ORCID: 0000-0002-0907-9582
[2]Clayton State University, College of Business, Morrow, Georgia, USA.
crnarayanaswamy@clayton.edu , ORCID: 0000-0003-2877-0333

To cite this document
Bilbeisi, K., Narayanaswamy, C R. (2023). Did Walgreens and Rite Aid benefit from their 2017 deal? Pressacademia Procedia (PAP), 16, 1-6.
Permanent link to this document: http://doi.org/10.17261/Pressacademia.2023.1655

ABSTRACT
Purpose- After several attempts that extended over two years, in 2017 the U.S. Federal Trade Commission approved Walgreens' proposal to buy nearly half of Rite Aid stores. The two companies were in the same line of business making the merger fall in the category of horizontal mergers. The main benefits of horizontal mergers are cost savings from improved operational efficiency and superior bargaining power with respect to suppliers. Using annual financial statements, we examined the performance of Walgreens and Rite Aid over the four-year period since the acquisition of Rite Aid stores by Walgreens. The examination is useful because the Federal Trade Commission was not in favor of Walgreens' earlier proposal to merge completely with Rite Aid, but later allowed it to buy almost half of Rite Aid stores. The present study examines whether the revised proposal benefitted both Walgreens and Rite Aid.
Methodology- We collected annual financial statement data of the two companies from Mergent database and analyzed the common size statements and the relevant financial ratios.
Findings- Analysis of profitability ratios indicate profit margins (gross as well as net) continued to decrease for both companies even after the acquisition. Both companies showed improved operational effeciency as reflected in Inventory Turnover and employee productivity, but Walgreens had a superior performance.
Conclusion- Only four years have passed since Walgreens acquired Rite Aid stores. Our analysis of the limited data indicates that Walgreens seems to have benefitted more from the deal. Rite Aid, by selling about 46% of its stores to Walgreens in 2017, became a much smaller company. The smaller size did not affect the cost of inventory or financing, but its profitability did not improve.

Keywords: Walgreens, Rite Aid, drugstores, pharmacies, mergers
JEL Codes: G34, M41, M10

1. INTRODUCTION

Drugstores and pharmacies have always been an integral part of the healthcare system. Although most drugstore businesses started as a single store and remained so, a few grew to become regional and national chains. In the U.S., three such large drug store chain companies are Walgreens, CVS, and Rite Aid. The three companies were ranked as the top three drug store chains in the U.S. for several years. Despite competition among themselves and other companies, these three companies retained their positions as major drug store chains in the U.S. through consistent growth. The growth of these companies has

Walgreens was founded in 1901 as a single store in Chicago. It took seven years to start the second Walgreens store. However, by 1926 it grew to become a chain of 100 stores. It crossed the 1,000 mark in 1982, and by the year 2015 it operated at approximately 8,200 locations and became the largest pharmacy chain in the U.S. It also gained exposure to the European markets through its acquisition of Boots Alliance, a large European drug store chain. Walgreens hoped to further increase its operations in the U.S. market, and in 2015 it offered to buy Rite Aid for $9.4 billion.

Rite Aid Corporation also started as a single drug store. It began operations in 1962, opening its first store in Scranton, Pennsylvania. The number of locations it operated grew to 267 by 1972 and to 4,000 by 1996. When Walgreens made its offer to buy Rite Aid in October 2015, Rite Aid had about 4,600 stores. Walgreens and Rite Aid wanted to merge into one company and sought the Federal Trade Commission's approval in 2015. The comission was not in favor of the proposal. Two years later, in 2017, the commission approved Walgreens' proposal to buy about half of Rite Aid's stores. This study examines whether the two companies benefitted from the transaction.

2. LITERATURE REVIEW

In a review of the literature pertaining to the effect of mergers and acquisitions on corporate performance, Ismail, Abdou, and Annis (2011) categorize the studies into four groups based on the use of (1) Market Measures (such as stock price reaction, abnormal returns, etc.), (2) Accounting Measures [Rhoades (1998, Avkiran (1999), and Ibrahimi and Meghhouar (2019)], (3) Mixed Measures [Healey, Palepu, and Ruback (1992)], and (4) Qualitative Measures. The present study falls in the second group of studies that use accounting measures. Several of these studies, using data on a sample of mergers, test hypotheses on whether mergers result in improved operating and financial efficiency, whereas some restricted their analysis to a single acquisition or merger [Cabanda and Pajara-Pascual (2007), Agarwal and Mittal (2014), and Bilbeisi, Narayanaswamy, and Dinh (2018)]. This study also examines changes in the operating efficienies of a single transaction – acqusition of a significant portion of Rite Aid stores by Walgreens.

The acquisition of Rite Aid drug stores by Walgreens extended over two years. During this period, there were three major announcements regarding Walgreens' plans to purchase Rite Aid stores. The first announcement (made in 2015) was that Walgreens would buy the entire Rite Aid company. The announcement resulted in an increase in the stock price of both companies. The next two announcements on Walgreens' offer to buy fewer Rite Aid stores resulted in considerable decrease in Rite Aid's stock price, but Walgreens' stock price changed very little. Stock price reactions to announcements indicate investors' perception of future performance of the companies. In this case, the steep drop in price of Rite Aid could have portended its future performance. The absence of change in the stock price of Walgreens' stock must have also reflected investors' expectation that there may not be significant change in Walgreens' future performance. The focus of the study is to examine the performance of Walgreens and Rite Aid after Walgreens acquired almost half of Rite Aid stores in 2017. Several stores sold by Rite Aid to Walgreens were located close to Walgreens stores. Walgreens closed many of the Rite Aid stores it acquired. Using financial statements, we compare the performance of Rite Aid and Walgreens stores before and after the acquisition.

3. DATA AND METHODOLOGY

For our analysis, we mainly use the annual reports published by the companies primarily for the shareholders and the public. The Securities and Exchange Commission requires large, publicly held companies to annually file a 10-K report. This filing is generally a detailed document, which regulators, analysts, and researchers use. Although financial statements are available on a quarterly basis, we use annual data to avoid seasonal fluctuations and focus on annual changes. However, the fiscal year reporting date for the two companies differed somewhat. The reporting dates were August 31st for Walgreens, and end of February or beginning of March for Rite Aid. The maximum gap between the dates was about six months. We use the end of the year closest to the reporting date as the year for which the report was made. For example, we use the report made by Walgreens on August 31, 2021 as the annual report for 2021, whereas the Rite Aid annual data reported in February of 2022 is used as the data for the year 2021.

We examine whether the transaction between Walgreens and Rite Aid benefitted both companies by analyzing the financial ratios that measure a firm's profitability, activity, costs, etc. Improvements in performance of the company after the reorganization should be reflected in better financial ratios for the post-acquisition period compared to the pre-acquisition period. We used Mergent as the primary source of data. Although the Mergent database reports several financial ratios, some of the ratios we needed were not readily available. We computed these ratios from the reported financial statements. However, to confirm consistency, we compared our estimates of other ratios available in Mergent and did not find significant difference between the two.

4. FINDINGS AND DISCUSSIONS

The FTC approved the 2017 proposal that resulted in Walgreens buying almost half of Rite Aid's stores. We use two four-year time segments for comparing performance of the two companies. These are the four-year period before 2017 and the four-year period after 2017. The transaction between Rite Aid and Walgreens reduced the size of Rite Aid significantly. The size increase of Walgreens was relatively small because Walgreens was a much bigger firm than Rite Aid.

4.1. Profitability and Expenses

Profitability is the key to long term survival of a firm. Shareholders invest in firms with the hope of getting a fair return on their investment. Before the shareholders get the returns, however, the firm must pay for the inventory used for generating the sale, operating expenses it incurred, and the taxes it owed. The amount left from the revenue after each of the above-mentioned expenses are categorized as gross profit, operating profit, and net profit, respectively.

We first compute the gross profit margin for Rite Aid and Walgreens before and after the transaction in 2017. Table 1 contains the gross profit margin for the two companies for the period 2013-2021. Figures in the table indicate that the gross profit margin of both Rite Aid and Walgreens decreased in the post-2017 period compared to the pre-2017 period. For Rite Aid, the average annual gross profit margin during the years 2013-2016 was 26.60% and for the 2018-2021 period it was 20.88%,a decrease of 5.72%. For Walgreens, the average annual gross profit margin fell from 27.24% to 21.66%, a decrease of 5.58%, in the same timeframe. For both companies the gross profit margin fell by almost the same amount. We can also note that the year-by-year difference in gross profit margin between the two companies also did not change much in most of the years. Subtracting the gross profit margin for Walgreens from Rite Aid for each year, as shown in the last row of Table 1, we note that the difference was about 0.5% for most of the years. The largest differences were in 2016, 2017, and 2018, the years surrounding 2017 when the transaction between the two companies was approved. The figures indicate that Rite Aid and Walgreens generated about the same gross profit per dollar sold before and after the 2017 sale. Based on this data, it appears that Rite Aid, despite its reduced size after 2017, was not disadvantaged in procuring inventory.

Table 1: Gross Profit Margin (%)

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021
Rite Aid	28.69	28.56	25.46	23.67	22.20	21.61	21.56	19.57	20.78
Walgreens	29.24	28.23	26.03	25.46	24.67	23.41	21.97	20.08	21.18
Rite Aid-Walgreens (RAD-WG)	-0.55	0.33	-0.57	-1.79	-2.47	-1.80	-0.42	-0.51	-0.40

Table 2 shows the Net Profit Margin for the two companies from 2013 to 2021. The Net Profit Margin for Rite Aid was considerably lower than Walgreens' in all the years except 2014 and 2017. This was despite both companies having had almost the same gross profit margin. The average net income margin for Rite Aid during the pre-2017 four-year period was 2.37%. The margin was also positive in all four years. In the post-2017 period, however, the average was negative 1.65%. It was not positive in any one those years. The decline in average net income margin for Rite Aid from the pre-2017 to post-2017 period was 4.02%. For Walgreens there was also a decline in average net income between the two periods, but the difference was much smaller. The decline in average net income for Walgreens was only 1.24%. Further, Walgreens did not have negative net income in any year. Comparison of year-by-year net income margin of the two companies also reveals that the net income of Rite Aid was less than Walgreens' in all the years except 2017. To gain understanding of this, we examine the components of expenses and associated activities that could have contributed to it. After the cost of inventory is accounted for in the gross profit margin, the largest component of expenses is attributed to selling, general and administrative expenses (SG&A).

Table 2: Net Income / Sales (%)

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021
Rite Aid	0.98	7.95	0.54	0.01	4.38	-1.95	-2.06	-0.38	-2.19
Walgreens	3.39	2.66	4.14	3.57	3.47	3.82	2.89	0.30	1.90
RAD-WG	-2.55	5.29	-3.60	-3.56	0.91	-5.78	-4.96	-0.68	-4.09

Table 3 contains the annual Selling, General & Administrative (SG&A) expenses as a percentage of net sales, from 2013 to 2021. For the pre-2017 years, the averages were 23.95% for Rite Aid and 22.51% for Walgreens. For the post-2017 period, the average of this expense category was 20.50% for Rite Aid and 18.76% for Walgreens. For both companies, the SG&A expenses (as a proportion of net sales) fell by almost the same amount (3.45% for Rite Aid and 3.75% for Walgreens). But Walgreens had significantly lower SG&A expenses compared to Rite Aid every year except 2020. On average, Walgreens' SG&A (as a proportion of sales) was about 1.44% lower than Rite Aid's in the pre-2107 years and about 1.74% in the post-2017 years. It indicates that Walgreens has been more efficient in its operations compared to Rite Aid.

Table 3: SG&A / Sales (%)

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021
Rite Aid	25.70	25.24	22.82	22.05	21.60	21.22	20.92	19.37	20.49
Walgreens	24.29	23.55	21.82	20.37	20.08	18.68	18.44	19.38	18.55
RAD-WG	1.41	1.69	1.00	1.68	1.52	2.54	2.48	-0.01	1.94

We next investigated the possibility that the extent of debt financing could have affected the net income. Table 4 contains the data on net interest payments made by the two companies, expressed as a percentage of sales. The table indicates that Rite Aid performed well with respect to debt since 2017. After selling many of its stores to Walgreens for $4.38 billion in 2017, Rite Aid reduced its debt by about $3.92 billion. The annual interest paid on debt by Rite Aid (expressed as a percentage of sales), although higher than Walgreens' in the post-2017 period, has been decreasing quickly.

Table 4: Interest / Sales (%)

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021
Rite Aid	1.66	1.50	1.46	1.32	0.94	1.05	1.05	0.84	0.78
Walgreens	0.23	0.20	0.58	0.51	0.59	0.47	0.51	0.46	0.68
RAD-WG	1.43	1.29	0.88	0.81	0.36	0.58	0.53	0.38	0.10

4.2. Activity Ratios: Asset Management Efficiency, Asset Liquidity, and Employee Productivity

Examination of financial statements indicate that the two companies, Rite Aid and Walgreens, differed significantly in their Net Income margin since 2017. The poorer performance of Rite Aid could not be due to inefficiency in procurement or costs related to inventory because the cost of goods sold were almost the same for the two companies. The difference in performance could not be due to higher levels of debt commitments either. Rite Aid in fact fared well by reducing its debt level after 2017 from the proceeds of the sale of its stores to Walgreens. The low net income of Rite Aid was likely due to its higher operating expenses. To investigate this, we next examine their activity ratios.

4.2.1. Inventory Turnover

Inventory turnover measures the efficiency of the firm in managing and selling inventory. It measures the number of times average inventory was sold during the accounting period. It is a gauge of the liquidity of a firm's inventory. The ratio is calculated by dividing the annual Cost of Goods Sold by average inventory for the corresponding year. As shown in Table 5, both firms increased their inventory turnover after 2017. However, Walgreens' inventory turnover ratio was higher than Rite Aid's every year, before and after 2017. For the post-2017 period, Walgreens' average inventory turnover ratio was about 1.81 higher than Rite Aid's. The higher measures for Walgreens indicate its inventory was being sold and replenished more frequently than Rite Aid's.

Table 5: Inventory Turnover

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021
Rite Aid	5.92	6.45	8.21	9.06	7.22	9.24	9.07	10.21	10.18
Walgreen	7.36	8.48	10.37	9.92	9.98	10.91	11.3	11.87	11.86

4.2.2. Short-Term Solvency (Current Ratio)

Current Ratio is a commonly used measure of short-term solvency, the ability of a firm to meet its debt requirements as they come due. Current Liabilities are used as the denominator of the ratio because they are considered to represent the most urgent debt, requiring retirement within one year or one operating cycle. The available cash resources to satisfy these obligations must come primarily from cash or conversions to cash of other current assets.

Table 6: Current Ratio

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021
Rite Aid	1.71	1.7	1.52	1.69	1.37	1.68	1.34	1.38	1.18
Walgreen	1.34	1.38	1.19	1.52	1.07	0.82	0.73	0.67	0.72

Table 6 shows the annual Current Ratio of Rite Aid and Walgreens from 2013 to 2021. Current ratio declined for both Rite Aid and Walgreens after 2017. The decline has been substantially greater for Rite Aid compared to Walgreens. The current ratio for Walgreens decreased from 0.82 in 2018 to 0.72 in 2021, whereas for Rite Aid the decrease was from 1.68 to 1.18. Although the ratio declined for both companies, the current ratio for Rite Aid has been significantly higher compared to Walgreens. The high value of this ratio for Rite Aid could be indicative of carrying higher inventory compared to Walgreens. It could partly be the reason for Rite Aid's lower inventory turnover ratio discussed earlier.

4.2.3. Asset Turnover

The efficiency with which assets were utilized in the business can also be measured by Total Asset Turnover Ratio. It is computed by dividing net sales by average total assets for the period. The resulting number shows the dollars of net sales produced by each dollar invested in assets. Table 7 shows the total asset turnover for Rite Aid has been higher than Walgreens', every year, before and after 2017. Rite Aid's asset turnover was higher averaging 2.63 compared with Walgreens which averaged 1.84, for the four post-2017 years. These figures indicate that Rite Aid likely made better use of its non-current (fixed) assets.

Table 7: Total Asset Turnover

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021
Rite Aid	3.65	3.37	3.06	2.87	2.09	2.62	2.58	2.57	2.76
Walgreen	2.09	2.10	1.95	1.66	1.70	1.96	2.02	1.80	1.57

4.2.4. Employee Productivity

Turnover ratio measures the effectiveness with which physical assets were used to generate sales. But sales are also generated by employees. A popular measure of employee productivity reported annually is the revenue generated per employee. Like other items on the balance sheet, the number of employees reported in the annual financial statements are year ending figures. To get the annual sales per employee, therefore, we divide the annual sales by the average of the reported year ending employment figures. Table 8 shows the revenue generated per employee for the two firms during the years 2013-2021.

To investigate employee productivity, we express the annual revenue per employee as a product of two components, namely "Total Assets per employee" and "Sales per dollar of Total Assets". The second ratio is the same as "Total Assets Turnover Ratio" which we have already discussed. Revenue generated per employee can be written as a product of the two ratios.

$$\text{Revenue per employee} = \left(\frac{\text{Total Assets}}{\text{Employees}}\right) \times \left(\frac{\text{Sales}}{\text{Total Assets}}\right) \quad (1)$$

The decomposition of the "Revenue per employee" ratio, as shown above, implies that changes in revenue generated per employee, an important measure of the utilization of employees, can be due to the two factors that interact in a multiplicative fashion.

Table 8: Employee Productivity

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021
Sales per Employee									
Rite Aid	287	298	347	375	295	386	425	481	477
Walgreen	296	306	339	326	335	376	393	415	410
Assets per Employee									
Rite Aid	79	89	114	131	141	148	165	188	173

Walgreen	141	146	174	196	197	192	195	230	261
Total Asset Turnover									
Rite Aid	3.65	3.37	3.06	2.87	2.09	2.62	2.58	2.57	2.76
Walgreen	2.09	2.10	1.95	1.66	1.70	1.96	2.02	1.80	1.57

Table 8 shows revenue per employee, total assets per employee, and total asset turnover for Rite Aid and Walgreens from 2013 to 2021 in three panels, one for each ratio. It can be noted that Rite Aid exceeded Walgreens in revenues generated per employee every year since 2017. It achieved higher revenue generation despite having, on average, lower amount of assets per employee compared to Walgreens. The higher annual revenue per employee, with lower assets per employee, indicates that Rite Aid's employee productivity was better than that of Walgreens during the four years since 2017.

5. CONCLUSION AND IMPLICATIONS

Analysis of financial statements is important, even necessary, for making right decisions. Information obtained from financial analysis are the basis for making decisions, both internally and externally. The main objective of our analysis was to examine if both Rite Aid and Walgreens benefitted from the deal that was approved by the Federal Trade Commission in 2017. Rite Aid sold 1,932 of its stores to Walgreens in return for $4.38 billion.

Our analysis indicates that Walgreens and Rite Aid both had comparable performances in managing the costs of inventory. The cost of goods sold for both companies was not significantly different from each other. On the financing side, Rite Aid narrowed its debt financing cost (as a proportion of sales) since selling its stores to Walgreens. The main difference in theirperformance was in the operating expenses. The Sales, General, and Administrative expenses per dollar sales was significantly and consistently lower for Walgreens compared to Rite Aid. We attempted to find the underlying reasons for this difference in efficiency. Analysis of activity indicate that Rite Aid had lower inventory turnover compared to Walgreens in all the years, before and after 2017. The lower inventory turnover ratio is also substantiated by higher Current Ratio of Rite Aid, indicating that Rite Aid might have been carrying more inventory relative to Walgreens. However, on another important measure of activity, namely "Revenue Generated per Employee," Rite Aid did significantly better than Walgreens. Rite Aid's employees achieved this despite having lower total assets per employee.

A likely reason for Rite Aid's lower net income margin compared to Walgreens seems to be its higher Sales, General, and Administrative expense. For a more detailed analysis, we need information on the components of the SG&A that are not currently available in published statements such as 10-K reports.

One may note that Rite Aid, after the sale of its stores to Walgreens, became a much smaller firm than it used to be prior to the 2017 deal with Walgreens. It was also subject to competition from several drugstores located in grocery stores and clubs such as Costco and Walmart, in addition to the traditional drug store chains. As these changes in the landscape of the drug store industry were anticipated, the Federal Trade Commission could have favorably considered the merger of the entire Rite Aid Corporation with Walgreens when the proposal was first made in 2015.

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