

Group Name : *Dolphin*  
 Date : 10/09/2001

**REVCO DS, Inc.**

**1. Question**

Analyze Revco's profitability for 1986. How strong does profitability in the drugstore division appear to be, relative to competitor? Does Revco appear to have a competitive advantage in that line of business? What is your assessment of Revco's prospects for future profitability?

**Answer**

**PROFITABILITY ANALYSIS**

	Competitors 1985	1986	1985	% Increase (Decrease)
EPS		1.72	1.06	62%
ROE		0.134	0.086	56%
Pretax ROA	0.14 – 0.15	0.138	0.098	41%
Profit / Sales		0.024	0.019	28%
Profit / EBIT		0.513	0.555	-8%
EBIT / Sales	0.048 - 0.068	0.047	0.034	38%
EBIT / Margin		0.178	0.135	32%
Margin / Sales	0.25 - 0.30	0.263	0.251	5%

Revco's profitability (profit to sales) in 1986 increased by 28% from 1985 which was primarily due to the better operating efficiency as shown by the increasing EBIT / Margin of 32%. As competition in the drugstore industry became tighter, in 1985 Revco ran a price-reduction program and expected to boost its sales to cover the reduction in profit margin. However, it did not achieve the expected sales volume. Furthermore, the loss of Odd Lot also badly affected Revco performance since 1985. In response to the declining profitability, Revco abandoned the price-reduction program in mid 1986 and improved its operations by reviewing the performance of existing stores which resulted in closing of under-performing stores and opening new stores in strategic areas, increasing gain in the pharmacy sales and improvement in the operations of Odd Lot to reduce its loss. Such improvements increased significantly the operating efficiency that improved Revco's profitability in 1986 comparing to previous year. However, its profitability was still below the average industry rate. ROA reached 13.8% that was slightly below industry

rate of 14% - 15% while EBIT to Sales was 4.7% that was also lower than competitors that were ranging about 4.8% - 6.8%. It was obvious that performance review on the stores operations had reduced its expenses but did not have much affect on the profit margin, which was 26.3% comparing to the average industry rates of 25% - 30%. Revco's acquisition of Odd Lot by end of 1984 only incurred a huge loss. Competitors (which also acquired or merged with other companies) might be able to operate more efficient that cause more difficulties for Revco to compete. The operational results of the first quarter of 1987 did not show any significant improvement. There was no any major strategies that could be a strong profitability driver.

Revco was owned and run by the management that was well experienced in the drugstores chain business since mid-1950s. Once it became the nation's largest drugstore chain, Revco benefited from its large economies of scale, wide channel of distribution and relationship with its stakeholders. The firm had relatively aggressive marketing strategy by implementing discount merchandising, product differentiation, personalized service and longer trading time. Revco was the pioneer in discount merchandising and promoting seven-day shopping. Despite the wide variety of products it sold, it still focused on drugs, health and beauty aids, and toiletries that represented 75% of total sales. Revco positioned itself in the market of small area to avoid competition with the deep discount stores that required a large population center to support profitable operations. It seemed that the firm had competitive advantages in the line of business at the early years but then it turned out to be not convincing since mid-1980s. Other firms that had entered into the market promoted new forms as "combo" stores, deep-discount stores, food stores and mass merchandising with all new offers and marketing strategy that caused a very tight competition in the market. Revco had no major strategy in expanding its market share. The market players continued growing, and in response to the adverse condition, some had performed consolidation and restructuring. Revco did the same with Odd Lot, merchandising closeout goods, but failed to achieve the synergy and faced management conflict after the acquisition. The industry moved and there might be some changes in consumer behavior as well. Hence, Revco did not show any potential ability to move ahead its competitors.

Revco's performance was not compelling to reach much higher profitability in the future. Revco's future achievement depended on the success in implementing the planned improvements in operations that would increase its operating efficiency. Divestiture program, cost cutting and resolution on Odd Lot controversy were only part of the solutions. The firm needed to increase its profit margin as well. It took however more than effort to build a new strategy for competing in the changed industry. Revco attempted to raise additional fund and change its capital structure through leverage buy out (LBO). With LBO it might obtain a source of financing to support the operations and eliminate the agency problem. The stock repurchase structured a decrease of outstanding shares from USD 36.7 million to 34.3 million, which might increase the return on common stock equity. However, it would also involved USD 245 million preferred stock issuance with dividend rate about 12% - 17.6% per annum and USD 1,159 million debt issuance with interest rate about 9.25% - 13.30% per annum. The firm should pay the LBO fee and expenses of USD 78 million (about 5% of the LBO proceed of USD 1.449

billion) and retire USD 117 million debt with interest rate of 10% per annum that was relatively lower comparing to the average LBO financing rates. With such a high cost of financing, the firm should be able to use effectively all the sources and properly execute the improvement program. It would achieve the LBO objective if it could reach an adequate level of profit to cover the cost of capital.

## **2. Question**

Jacqueline Walker has at her disposal a pre-LBO management projection and a pre-LBO analyst forecast. Discuss how much emphasis she should place on this information as she proceeds with her analysis.

## **Answer**

The management projection had more complete information and detailed supporting data than the analyst forecast. The management certainly was more optimistic than the analyst. In using such information, Walker should be aware of the management interest and asymmetric information. As the analyst, she might be lack of certain important information. To proceed with her analysis, she could use the management projection and consider the analyst point of view, the LBO impact, and all market or industry information.

The following are some critical points to be emphasized on the management projection and analyst forecast.

Management projection assumed that:

- Sales increased by 12% per year in existing stores, while new stores would be added at the rate that would have added 10% to retail space each year.

This seemed to be an optimistic growth rate considering that the increase in Gross Square Footage for the period of 1981 – 1986 are around 5% to 10% per year, it did not take into account the close out of stores due to performance review or LBO-related divestiture program while the competition in the following years still tend to be high. It also ignored the LBO-related expansion plan of opening 100 stores each year.

- EBITDA to Sales of 7.7% for fiscal 1988 through 1991.

This was a high return as the ratio in fiscal 1984, 1985 and 1986 were 9%, 4.6% and 5.9%, respectively, or in average of 6.5%. For the first quarter of fiscal 1987, the firm only reached 4.4%.

The management did not take into account any adjustment on the reduction in inventory of USD 75 million by end of 1987 to maintain inventory-to-sales ratio at 17% at year-end. It also did not consider the reduction in selling, general and administrative expenses of USD 24 million in 1987, increase in depreciation and

amortization related to the revaluation of assets at the time of LBO by USD 35.4 million in 1986 and USD 8.2 million in the first quarter of fiscal 1987.

- The projection did not include the impact of USD 1,449 million LBO financing, out of which USD 1,159 million will be obtained through debt issuance at interest ranging from 9.25% to 13.30% per annum. It also ignored the impact of Tax Reform Act of 1986, which would reduce the federal corporate income tax rate from 46% in 1986 to about 40% in fiscal 1987 and 34% thereafter.
- No other adjustment was made due to other LBO impacts, such as resolution of Odd Lot controversy. This resolution might improve its operations, reduction in capital expenditures from USD 95 million in 1986 to the amounts not exceeding USD 37.5 million in 1987 and USD 30 million in 1988 – 1992, change in the shares composition and number of shares outstanding that affect the EPS and dividend payment.

The analyst forecasted Revco sales would achieve USD 3 million in 1997 which was approximately the same as management projection but with lower EPS that was USD 1.90 compare to management's EPS of USD 2.27. He was more optimistic long-term, projecting sales of USD 4.150 million, earnings of USD 115 million and EPS of USD 3.55 by 1990. This forecast was higher than the best of last 7 years performance that achieved in 1994 when sales was USD 2,228 million with earnings of USD 93.41 million and EPS of USD 2.54. As the management projection, the analyst forecast ignore the effect of LBO financing and other LBO impacts, and the Tax Reform Act of 1986.

### 3. Question

Forecast sales and earnings for fiscal 1987 and fiscal 1988.

### Answer

Based on certain assumption as explained in attachment-1, the forecasted sales and earnings for fiscal 1987 and 1988 as follows:

#### **FORECAST SALES AND EARNINGS FOR FISCAL 1987 AND 1988 ( USD in Thousands )**

	1987			1988		
	Pre - LBO	Adjustments	Post - LBO	Pre - LBO	Adjustments	Post - LBO
<b>Net Sales</b>	3,017,181	(280,000)	<b>2,737,181</b>	3,379,243	(313,600)	<b>3,065,643</b>
<b>EBITDA</b>	207,579	(25,848)	<b>206,731</b>	260,202	(27,838)	<b>258,211</b>
		79,000			-	
		24,000			25,848	
		(78,000)			-	
<b>Depreciation and Amortization</b>	36,505	32,800	<b>69,305</b>	38,505	32,800	<b>71,305</b>
<b>Net Interest Expense</b>	31,691	(4,875)	<b>83,074</b>	30,700	(11,700)	<b>149,857</b>
		56,258			135,020	
		-			(4,163)	
<b>EBT</b>	139,383		<b>54,352</b>	190,997		<b>37,049</b>
<b>Income Taxes</b>	66,555	(43,987)	<b>22,568</b>	87,858	(75,261)	<b>12,597</b>
<b>Net Earnings</b>	72,828		<b>31,784</b>	103,139		<b>24,453</b>

#### **4. Question**

Forecast cash from operations for fiscal 1987 and fiscal 1988.

#### **Answer**

Based on certain assumption as explained in attachment-2, the forecasted cash flow from operations for fiscal 1987 and fiscal 1988 follow:

#### **FORECAST CASH FROM OPERATIONS FOR FISCAL 1987 AND 1988 ( USD in Thousands )**

	<b>1987</b>	<b>1988</b>
<b>Net Income ( Post LBO )</b>	<b>31,784</b>	<b>24,453</b>
<b>Adjustments to Reconcile Net Income to Cash From Operations</b>		
Depreciation and Amortization	69,305	71,305
Interest Expense	83,074	149,857
LBO Charges	78,000	-
Change in Working Capital	(40,082)	(46,260)
Loss (Gain) on Sale of Property and Plant ( related to divestiture program)	(79,000)	-
<b>Cash From Operations</b>	<b>143,081</b>	<b>199,354</b>

### **5. Question**

How much “margin for error” is in the Revco LBO? That is, how much could cash flows fall from your forecasted level before Revco would default on its debt payments?

### **Answer**

Based on our forecast that already included the LBO impact, the firm was able to service its debt in fiscal 1987. However, it could not afford the debt payment in fiscal 1988. It showed by the ratio of cash from operations to debt payment that below 1 as in the following table.

#### **CASH FLOW FROM OPERATIONS TO DEBT SERVICE ( USD in Thousands )**

	<b>1987</b>	<b>1988</b>
<b>Cash Flow from Operations</b>	<b>143,081</b>	<b>199,354</b>
Debt Payments		
Principal	45,000	142,500
Interest	83,074	149,857
<b>Total Debt Payment</b>	<b>128,074</b>	<b>292,357</b>
<b>Cash Flow from Operations to Debt Service</b>	<b>1.12</b>	<b>0.68</b>

The cash flow from operations are calculated based on the earnings that might be achieved by the management with optimistic assumption that for fiscal 1988 it would reach sales increase of 12%, ratio of EBITDA to Sales of 7.7% and LIBOR rate at 6.5%. If the firm could not achieve the expected return and or the LIBOR rate increase, the firm’s cash flows would be more deteriorated.

For fiscal 1987, the management projected sales increase of about 10%, from USD 2,743,178 thousands in 1986 to USD 3,017,181 thousands in 1987 and EBITDA amounting USD 207,579 thousands, or 6.9% to Sales. The firm might be able to reach the expected sales increase but ratio of EBITDA to Sales of 6.9% was too high comparing to that of the last two years which were 4.6% and 5.9%, respectively.

With assumption that ratio of EBITDA to Sales in fiscal 1987 was 6%, the cash flow from operations would fall by USD 18,241 thousands (from USD 143,081 thousands to USD 124,840 thousands) so that cash flow from operations was not adequate to cover the debt payments as specified in the following table.

**CASH FLOW FROM OPERATIONS TO DEBT SERVICE****( USD in Thousands )**

	<b>1987</b>
<b>Cash Flow from Operations</b>	<b>124,840</b>
Debt Payments	
Principal	45,000
Interest	83,074
<b>Total Debt Payment</b>	<b>128,074</b>
<b>Cash Flow from Operations to Debt Service</b>	<b>0.97</b>

Considering the market condition and financial performance of the firm, while it was very hard to execute the planned improvement; it was likely that the firm could not achieve the expected return and therefore would default on its debt payment.