Take Stock – Loblaw and Shoppers Add More Sizzle to an Already Sizzling Week

Description

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Dear Fellow Fools,

Shoppers Drug Mart (TSX:SC) shareholders went to sleep this past Sunday owning one of the Canadian market's best ways to play the ageing population theme. By Monday morning, all that was altered after it was announced that **Loblaw** (TSX:L) had swooped in and muddied the waters. A Canadian grocery/drug retailing giant is on the verge of being born.

This week's Take Stock is going to touch on some of the pertinent details behind this mega-merger, as well as how shareholders might think through the options that are currently available to them. These same options hold true for most M&A activity, therefore, there's a little something for all in this week's letter.

The deal

By now, the specifics of the Shoppers takeover have been widely disseminated. In a nutshell: Loblaw is offering a combination of cash and stock that amounted to a 27% premium over where Shoppers closed last Friday. (We went over more of the details in a recent Fool.ca post.)

Basically, if you are an owner of Shoppers' shares and hold your position until the deal closes, you are likely to own some shares in the combined entity when all is said and done.

We'll come back to this deal structure a little later as it has implications for how investors think about corporate transactions.

The creation

By all accounts, this merger has been undertaken to help both companies not only stave off the constant creep of competition that has become a theme in the Canadian retail space, but also to inject some much-needed options for growth into the business model for each.

These are two very mature businesses with rather anemic same-store sales growth in recent times. The combination will provide Loblaw a way to bolster its medical/pharmacy unit, while Shoppers will be able to increase its food offering by rolling out President's Choice branded products.

In addition, this deal opens the possibility that a chunk of the existing 1,200+ Shoppers outlets could effectively become retail banks that offer PC Financial related products. And with more than 10 million members in Shoppers' Optimum loyalty card program, the opportunities to tailor specific, customized marketing campaigns to consumers appear endless.

Merger considerations

As with any corporate merger/transaction, investors have some decisions to make here. And we're not talking about voting for or against the deal. We individual investors have very little say when it comes to these matters — the institutional players carry all that weight.

No, we're talking about how to think about your position if you own the targeted company, which in this case is Shoppers. You've got options. Three in fact …

Option 1

Liquidate your entire position in the target — right now. Essentially, take the money and run. Shoppers currently trades just below $60, which is a healthy bump from where it closed last Friday. You can sell your shares, pocket the cash, and move on with a smile on your face.

This option removes a lot of risk from the equation, and in this case, probably doesn't leave much reward on the table — at least in the short term.

This deal will go before Canada's Competition Bureau, and though it's unlikely to be blocked, there's always a chance. How smart would selling your shares look should this scenario evolve? (Hint: Very!)

On the flip side, it eliminates you from benefitting should another, higher bid for Shoppers appear. It's long been thought that **Walgreen's** would someday be a natural suitor for Shoppers. However, the likelihood of this occurring, given the multiple that Loblaw is paying, appears pretty low.

Option 2

Do nothing. Hold your Shoppers shares and collect the cash and Loblaw shares once the deal is finalized. By doing nothing, you run the risk of the deal falling through (Competition Bureau, lending arrangements fail) and are implying that you believe in the combined entity and are happy to stick with it.

You also run the risk that at some point between now and when the deal closes, the stock market receives a haircut, thus pulling down the value of Loblaw shares, which in turn will negatively impact the value of your Shoppers shares. There is an element of market risk to this deal due to its cash/share structure.

Because of this structure, there is not a firm price at which Shoppers is being purchased. Shoppers' shares are now linked to the performance of Loblaw shares. If Loblaw shares go up/down, so too will Shoppers shares. Therefore, there is not only an element of market risk involved with continuing to hold your Shoppers position, but also some company-specific risk, should Loblaw by chance come out with a market-moving bit of news between now and the deal's close.

Given Loblaw's rather full valuation, there seems to be more downside than up under this scenario.

Option 3

The hybrid solution involves selling a portion of your holdings. This is the preferred route of many institutional investors but doesn't necessarily hold for us. If you own 1 million shares of Shoppers, it's relatively easy to piece off, say, 500,000, see what happens with the rest, and feel pretty good about yourself. If you own 100 shares, the formula doesn't hold. While this is in some ways a best-of-both-worlds approach, it may not apply to your specific situation.

The Foolish Bottom Line

For investors, the decision boils down to "regret minimization," a term I first heard from Motley Fool co-founder David Gardner, who in turn had it described to him by **Amazon.com** founder Jeff Bezos. These corporate transactions have a lot of variables at play. You want to make the decision that will minimize your regret, regardless of how it all plays out.

Even though we're dealing with a financial transaction, we suggest that whatever action Fools take, it should maximize the initial sense of "awesome" you no doubt felt when you first learned of the transaction. This doesn't always mean maximizing your profit. Understand your financial upside, and downside, before making a decision but under most of these takeover situations, your brain will thank you for taking the path of least resistance.

'Til next time … happy investing and Fool on!

Sincerely,

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The Motley Fool Canada

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CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:L (Loblaw Companies Limited)

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1. Investing

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