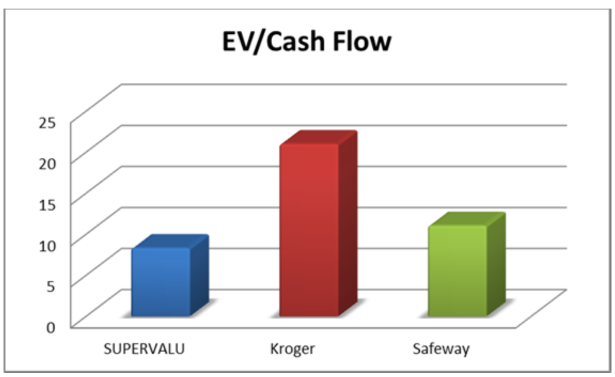
# SUPERVALU: Evaluating LBO Transaction Speculation

**Evaluation of the Price Proposed for SVU's Shares:**

We believe that \$6.00 per share would be a fair and reasonable offer by a private equity firm (pursuant to Barclays analyst Meredith Adler's June research piece on SVU) for SUPERVALU's (SVU) shares if a PE firm was to acquire SVU in whole. While it is a sharp increase from the \$2.22 that the shares traded at on October 5th, we believe that it is a fair price to the holders of SVU as well as a PE firm because of SUPERVALU's free cash flow generation. SVU is expected to generate \$900M in operating cash flows this year and \$400M in free cash flows even taking into account additional investments in price reductions in order to remain competitive with its peers. A \$6/share bid for the company values SVU's equity at \$1.284B and represents 3.2X SVU's free cash flow. The Enterprise Value implied for this deal is \$7.57B based on this bid and SVU's \$6.288B in outstanding debt. Based on the \$509M in Interest Expenses that SVU had incurred over the last 12 months, this offer is valuing the company at 8.3X Pre-Tax Adjusted Enterprise Free Cash Flows, which is less than its two immediate competitors Kroger (KR) and Safeway (SWY).




*Source: Morningstar Direct*

**Evaluation of the Interest Rate Coupon for SVU's LBO Related Debt:**

We can see that SVU is paying an average of 8% on its outstanding indebtedness and its bonds are trading at a significant discount to par value, particularly its long-term New Albertsons Inc bonds. We believe that an interest rate coupon of 7-8% for SVU's LBO Related debt would be fair because it is in line with what SVU is paying on its existing debt. It is also fair because as part of the deal, we would expect a private equity firm to be structuring the debt to offer an additional return to be paid at the debentures/debt's due date or in four years. We would expect a private equity firm to borrow more than the purchasing price as part of the transaction and use that extra borrowing in order to buy back a portion of SVU's currently outstanding bond issues that are trading at a discount in the secondary markets. We are also interested in seeing the expected tranche structures associated with the acquisition related debt for SVU and its PE acquirer. We would also be interested in seeing how the debt can be structured to enable the acquirer to make principal payments on the debt without having to pay penalties for doing the right thing (returning debtholder's money).

**Evaluating a Potential LBO of SUPERVALU:**

While we would benefit more from having detailed financial information from the company with regards to its individual traditional retail store banners, we can see the necessary information about SVU's Save-A-Lot segment and its Independent Wholesale Grocery Distribution operations that we would need in order to make our determination as to what value we would attribute to those segments.

SVU has $6.5B of total corporate-wide face value debt as of Q1 2013. This is before we take into account its $212M net discount on debt noted in the consolidated financial statements, resulting in total net debt and capital lease obligations of $6.288B as of Q1 2013. According to Bloomberg, we saw $4B of publicly traded bonds plus $2.5B in securitized loans which we assume that the lenders are going to be holding on to these loans rather than selling them in the open market. As for the current market conditions on debt finance, we would like to note that although investors are starved for yield, they have also learned their mistake from the debt fueled binge of the 2000s. One particular recent debt transaction we were aware of was CenturyLink's attempt to opportunistically refinance certain indebtedness of its wholly-owned subsidiary Qwest Communications International Inc. at attractive rates. Despite the fact that CenturyLink was an investment grade credit issuer, despite the fact that interest rates are at historical lows, despite the fact that CenturyLink has committed to paying down debt in order to maintain its investment grade rating and despite the fact that CenturyLink was only refinancing the debt, it was not able to execute the sale of the senior notes in order to refinance the debt from Qwest. Qwest has previously committed to redeem on October 26, 2012 all $550 million aggregate principal amount of its 8.00% Notes due 2015. Qwest now expects to fund this redemption with borrowings available to it under CenturyLink's revolving credit facility.

We would certainly see the use in reallocating SUPERVALU's debt, pension assets and liabilities and other general liabilities to the appropriate store banners and or business units. This way, it would be easier to break up SUPERVALU and to sell the various units in order to pay down the LBO related debt. The assets we would most like to see sold would be the Albertsons stores and the Shaw's/Star Markets stores.

We were especially interested in an acquirer selling off the traditional retail stores that SVU owns. SVU owns 435 of its stores and we believe that the sale of some or all of these stores could enable the company to reduce its outstanding indebtedness. We also believe that the company should consider selling off some of these stores outright rather than a sale-and-leaseback transaction resulting in the company having to pay lease payments to the buyer.

**Conclusion:**

In conclusion, we believe that while SVU is facing a challenging environment, it is still a profitable company and it is still generating free cash flows. We believe that there is value to be realized in SVU either as a stand-alone company or by selling off pieces of the operation. We cannot escape the fact that the company has nearly $6.3B in debt as of the previous quarter and the proposed LBO would add another $1.3B. However, the company owns 435 stores outright, which we estimate would be worth $8M-$15M to a buyer. If the company was to sell these stores to a buyer (whether a real estate investment trust or another retail chain) this would reduce the company's debt from the pro forma post-buyout level of $7.57B to $1B-$4B. This represents between 50%-85% of SVU's Pro Forma acquisition Enterprise Value of $7.57B. Although the company's cash flows are off the peak achieved in 2008, it still generated over $1B in operating cash flows in 2012 and is targeting $900M in cash flows in 2013. Free cash flows have been at least $400M every year since FY 2008 and have been primarily used to reduce outstanding indebtedness. Before SVU's weak Q1 2013 results, Barclays speculated that SVU would be an attractive LBO candidate. We agreed with David Dietze of Point View Wealth Management when he said that "SVU is cheap because it has been a problem child performer. It could make a good candidate for private equity because it is trading at such a very small multiple of earnings and cash flow". We believe that as long as SVU can stabilize its cash flows, revenues and profits, we believe that there is a strong possibility that it can pay off its 2014 debt with free cash flows rather than resorting to extend and pretend refinancing. We also believe that there is a strong likelihood of SVU executing a strategic transaction by selling off at least one of its 11 traditional retailing store banners, its Independent Wholesale distribution operations, its Save-A-Lot hard discount operations or even its pharmacy operations.

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***Disclosure: The author has a long position in SVU.***