Who Wins and Who Loses in Staples' Acquisition of Office Depota

This week, the nation's No. 1 office supplies retailer Staples (SPLS) announced that it plans to buy second-place rival Office Depot (ODP) for $6.3 billion. This announcement is part of a larger trend of consolidation and comes on the heels of Office Depot's merger with OfficeMax in 2013. When it was a much healthier business in 1996, Staples tried to merge with Office Depot, but the Federal Trade Commission blocked the proposed merger over antitrust concerns.

The two businesses are hoping that the competitive pressure of online retail will give it some leverage to enact the same merger almost 10 years later. This is certainly possible, but shareholders shouldn't fall prey to the merger hype. A critical analysis reveals that this merger is hardly in shareholders' best interests.

Just How Much Trouble is Staples In?

Staples had a good run from 2003 to 2009 when it grew after-tax operating profit (NOPAT) by 15% compounded annually. However, since 2009, Staples' NOPAT has fallen by an alarming 11% compounded annually. Over that timeframe, the company's after-tax margins fell from 6% to under 3%. Staples also has $4.1 billion in total debt at the moment, most of which is comprised of $3 billion in off-balance sheet debt in operating leases.

The biggest problem here is the company's plummeting margins. This trend reflects the commoditized nature of the office supply business, as well as the increased pricing pressure from online giant Amazon (AMZN) and brick-and-mortar behemoth Walmart (WMT).

Office Depot is in a similar situation. From 1998 to 2006, Office Depot grew NOPAT by 10% annualized. Then from 2006 to 2013, the company saw its NOPAT drop by 13% annualized. Over that timeframe, NOPAT margins fell from 5% to under 4%. Without the impact of the OfficeMax acquisition in late 2013, Office Depot's sales fell 2% year over year in the first nine months of 2014.

Is the Purchase a Good Idea?

Office Depot shareholders will get $7.25 in cash and 0.2188 of a share in Staples stock after the deal closes. The offer represents a premium of 44% over ODP's price on Feb. 2, before news of the talks was reported.

Office Depot soared 22% after news of the merger was announced while Staples gained 11 percent. Only one day removed from the news, Office Depot rose 2% while Staples fell 12%. This drop in Staples could be a signal that shareholders weren't pleased with the final deal.

Is the Purchase a Good Idea?

Including debt and cash on hand, Staples is paying $9.2 billion for Office Depot. Based on the return that Office Depot generated in the last 12 months — a NOPAT of $546 million — and the $9.2 billion in invested capital for the acquisition, Staples will be earning a return on invested capital (ROIC) of 6% from this acquisition, equal to its current ROIC.

Staples may not be destroying any value with this acquisition, but it's not creating any either. The company promises cost synergies of $1 billion, which can certainly be added to the list of positives from the deal. However, this figure is coming from Staples management, which is trying to sell shareholders on the acquisition, so $1 billion is almost certainly on the high side.

Unfortunately, there are more aspects that should weigh on investors minds.

The first is the fact that Staples' core business issues still remain. The decline in the company's margins over the past several years is primarily due to a combination of strong top line growth in lower margin categories like tablets and a decline in sales higher margin categories such as office supplies, as well as pressure in core categories such as paper and ink and toner. Similarly declining margins at Office Depot won't help this issue either.

The second issue here is that while the acquisition will create a larger office supplies retailer, scale only goes so far. Staples wasn't facing price competition from Office Depot — its margins were under attack by Amazon and

Walmart, both of which can undercut Staples on commodities like office supplies and distribute them more efficiently. A combined SPLS and ODP would have around $38 billion in annual revenue, compared to $484 billion for Walmart and $89 billion for Amazon. Even fellow brick-and-mortar competitor Target (TGT) has $74 billion in annual revenue. A merger here might produce some economies of scale, but it wouldn't put Staples and Office Depot at any less of a disadvantage to their bigger competition.

So Who Wins in this Acquisition?

- **Starboard Value:** This is the hedge fund that pushed Staples to undertake the acquisition. It last reported a 5% stake in Staples and a nearly 10% stake in Office Depot. SPLS is up roughly 14% and ODP 42% since the fund announced its stake. It's hard to lose when you're on both sides of the proposed deal.
- **Staples Executives:** Staples execs receive bonuses based on meeting earnings per share (EPS) and sales targets, as well as return on net assets. In addition, performance-based awards can be adjusted based on SPLS's return for shareholders being in the top or bottom third of the S&P 500. The effect of performance-based pay can be significant — 76% of the CEO's 2013 compensation was performance-based. In addition, no portion of any bonus is payable in the event the company fails to achieve the minimum EPS. After this happened in the past, the Staples board proposed an "extra award cycle" to remedy lower bonus payouts, despite the original cash-award program that was designed to punish underperformance. This acquisition will likely keep the company's management from missing their bonuses this year.

And Who Loses?:

- **Shareholders:** Staples reported that it secured a $3 billion credit facility and $2.8 billion six-year term loan financing to fund the deal. It will also suspend its share buyback program. While the acquisition isn't value-destroying on its face, we feel that there are likely other places for Staples to invest its capital, such as revamping its online platform to be more competitive. In addition, interest payments on this new debt will be skimming cash off the top of Staples already slim margins — cash that could have otherwise been reinvested or distributed to shareholders.

Takeaway: This Don't Bet on This Acquisition

Staples execs incentives are tied to those of the company's shareholders, but we think that this expensive merger emphasizes short-term gain over long-term business goals. It's likely a last-resort quick cash grab by executives with no other real plan for the business.

While the up and down movements of SPLS and ODP might look tempting to bet on, we hope that you don't speculate. Instead, we encourage you to build your strategy around strong businesses with reliable metrics like strong free cash flow and ROIC — in other words, businesses unlike Staples and Office Depot.

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