MFIF

Minutemen Fixed Income Fund

Rite Aid Corporation

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Investment Thesis

We recommend an overweight position of Rite Aid Corporation's 7.5% senior secured notes due 2025. Rite Aid (RAD) is an American drugstore chain based in Philadelphia, Pennsylvania. The company has been distressed recently after being plagued by scandals within management, deals that have fallen through, and weakened performance since the turn of the century. This has resulted in RAD losing share within a stable industry that has experienced tremendous tailwinds over the past 3 years, meaning they have been unable to capitalize on an increase in cash flow in a manner their competitors have, coincided with new competitors emerging. Because of the strain on operations, which has been compounded by the sale of stores, RAD's credit profile has continually deteriorated, most recently exhibited by discounted tender offer on the company's 2025 7.5% secured notes that if approved, would see a restructuring or elimination of the collateral package along with the release of covenants. While likely to be tendered and provide leverage and interest flexibility, we see this as a short-term solution to a long-term problem. Despite the company's poor industry positioning and worsening credit profile, through a recovery analysis we recommend a buy on RAD's 2025 notes, offering an annualized return of 13.46%.

Figure 1: Capitalization Table

Rite Aid Corporation (RAD) Capitalization Table ($ K)					
LTM Adj. EBITDA	**326,775**			**Debt/EV**	9.86x
Outstanding Debt and Leverage Metrics					
Type of Debt	**Rate**	**Maturity**	**Debt Outstanding**	**Price**	**YTW**
First Lien Secured Debt					
Senior secured revolving credit facility	3LM+125	8/21/26	1,370,026	99.990	4.92%
FILO Term Loan	1LM+250	8/21/26	347,921	94	9.19%
Second Lien Secured Debt					
7.5% senior secured notes	7.500%	7/1/25	480,368	74.015	21.12%
8.0% senior secured notes	8.000%	11/15/26	837,060	62.164	23.15%
Unguaranteed Unsecured Debt					
7.7% notes	7.700%	2/15/27	185,240	54.888	25.97%
6.875% fixed-rate senior notes	6.875%	12/15/28	2,040	54.873	20.14%
Total Debt			3,222,655		
Market Captialization			306,990		
Less: Cash			(46,800)		
Enterprise Value			3,482,845		

Source: Bloomberg Terminal, Company Filings, MFIF Analysis

Security Data

Maturity: 7/1/2025
Rating: CC/B3
Rank: 2nd Lien Secured
Coupon: 7.5%
Price: 74.0145
YTW: 21.12%
OAS: 1,689
Mty. Type: Callable

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Industry Overview

The retail pharmacy industry is a condensed market. Two major players, CVS (CVS) and Walgreens (WBA), dominate the industry, accounting for 24.5% and 18% of the total market share respectively. CVS operates 9,000 retail locations and 1,100 walk-in medical clinics, while WBA has 8,866 retail stores, both dwarfing Rite Aid's 2,352 locations. Walmart (WMT) and Amazon (AMZN) are also players within the industry, Amazon being more recent with their introduction of Amazon Pharmacy in November 2020. CVS, WBA, and AMZN are all looking to expand their offerings, mostly through at-home health service options for customers as the healthcare industry transitions towards a "post-covid" landscape. The retail pharmacy industry was valued at $534.21B in 2020 and is projected to grow at a CAGR of 6.16% to $861.67B in 2028.

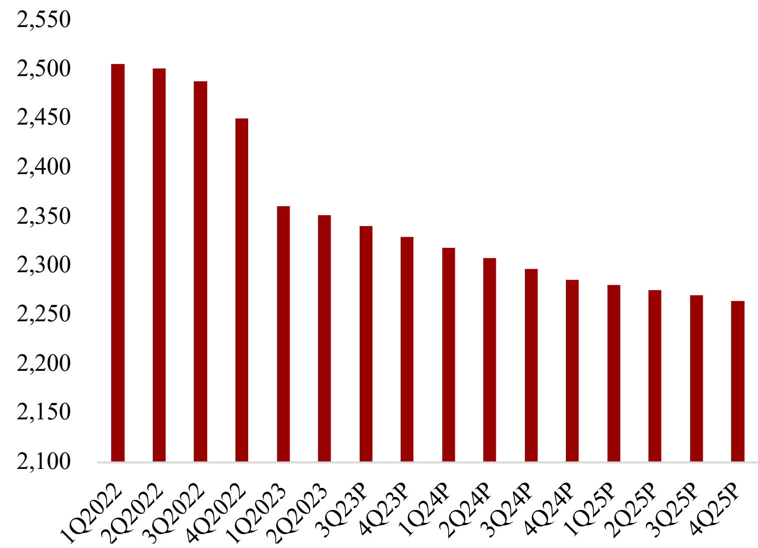
Company Overview

Rite Aid Corporation (RAD) is an American drugstore chain based in Philadelphia, Pennsylvania that was founded in 1962 in Scranton, Pennsylvania. After a long-sustained run of success, in 1999, Rite Aid experienced a scandal and has since been on a tumultuous road. In 2003, six executives, including CEO and son of the company's founder, Martin Grass, were convicted of a conspiracy of accounting fraud and falsifying filings with the SEC. In October 2015, Walgreen's was set to acquire Rite Aid, but the deal eventually fell through in 2017 because of regulatory measures. Instead, Rite Aid sold 1,932 of their over 4,000 stores to Walgreens for $4.3B in March 2018. Shortly after, Rite Aid engaged in merger talks with Albertsons, but that deal also eventually fell through.

Rite Aid's financial instability and uncertainty is still reflected in their current operations and financial performance. As of 2Q23, Rite Aid was operating 2,352 stores. RAD's present day operations consists of two main arms, their retail pharmacy segment, which typically accounts for 70-75% of total revenue, and the pharmacy services segment. Retail pharmacy is the traditional pharmacy model: dispense medication to those with prescriptions, provide shots, sell everyday care items, etc. Within the retail segment, pharmacy sales typically account for 70% of revenue with front-end sales, or the sale of items in the aisle, accounting for the rest. The focus of Rite Aid's pharmacy services segment is "Elixir", the company's pharmacy benefits manager (PBM) that offers technology solutions, delivery services, and other programs aimed at lowering the cost of medical care with the target or small to mid-market employers.

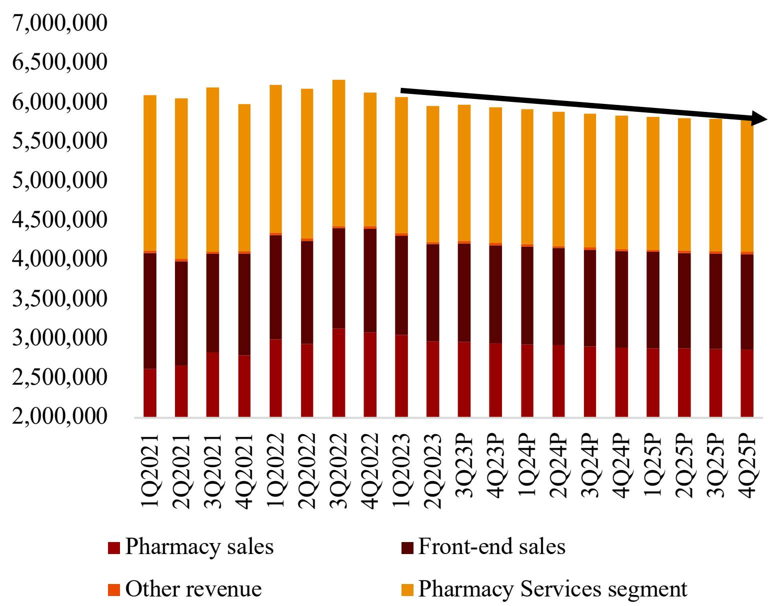
Deteriorating operations also put a strain on the company's credit profile. The only one of its comps with a HY credit rating, RAD is significantly more leveraged at 9.86x, whereas their closest direct competitor is WBA at 4.06x. Th company was recently downgraded to a "C" rating by Fitch Ratings and likely to be downgraded even further to "RD", or restricted default, on the back of their tender offer on the company's 2025 senior secured notes being accepted.

Figure 2: Store Count



Source: Company Filings, MFIF Analysis

Figure 3: Revenue Projections



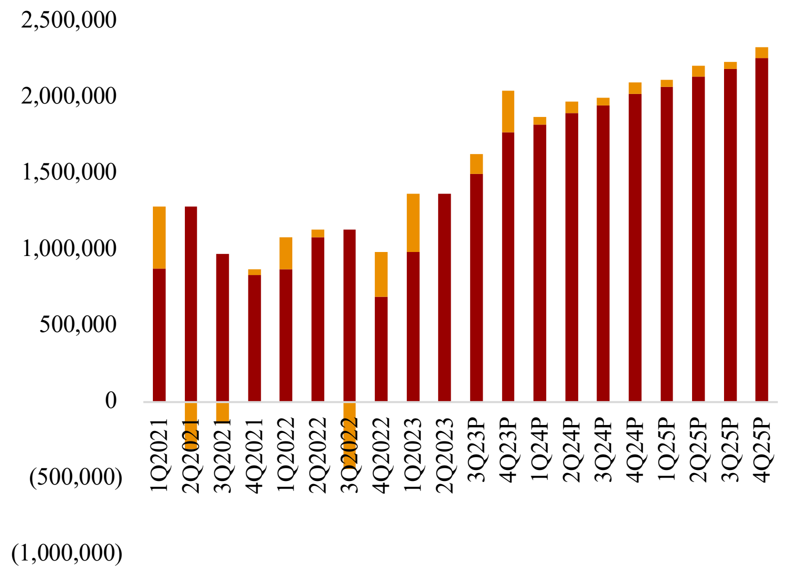
Source: Company Filings, MFIF Analysis

Investment Rationale & Catalysts

Weakening position in relation to competitors within the industry

Rite Aid's footing within an industry experiencing stable growth is weakening. With diminishing store count and dips in revenue, RAD does not possess the capability to regain the presence needed to challenge the likes of other industry mainstays, such as CVS and Walgreens, as well as newcomers like Amazon and Walmart. The prior mentioned decrease in store count of 2,352 as of 2Q23 has been juxtaposed by both CVS and WBA expanding their operations. Both companies have launched aggressive acquisition strategies, allowing them to diversify revenue streams and enter the home-care space. In September 2022, CVS announced an all-cash acquisition of Signify Health for $8B. More recently in October, Walgreens announced plans to fully acquire CareCentrix, buying up the remaining 45% of the company for $392M, valuing the company ~$871M and expanding Walgreens footing within homecare. RAD currently has no market share within the home-care space and has provided no guidance that it will take place in the short term. Even if it were on the horizon, such acquisitions given RAD's deteriorating performance and poor financials make such acquisitions highly unlikely. RAD's negative FCF and worsening revenue streams make such acquisitions to keep pace with their competitors increasingly difficult without worsening their already strained credit profile. Current macro conditions compound RAD's weak positioning relative to comps. The company is at greater risk than comps to inflationary pressures given their smaller scale of operations, making it more difficult for them to keep pace because of a lack of volume. In an industry that favors inorganic growth, securing necessary funding to compete with comps is becoming increasingly difficult. Given the company's ABL/FILO covenants, any acquisitions would likely require RAD to hefty unsecured funding from the high yield bond markets, which given current market conditions and necessary discounts for investors creates an unfavorable scenario for RAD. Any further issuances would also go back on the RAD's guidance to lower their interest expense, recently shown in the tender offer of the 2025 notes, as well as threaten general debt ratio covenants that forces RAD to remain above a 2x coverage ratio. Although coverage sat at 5.46x at the end of 2Q23, impending revolver draws and any more dips into the credit market put that ratio at risk. By YE2025, we project RAD's coverage ratio to be 2.54x, putting the company at significant risk of technical default. The company will almost certainly need to issue further debt, further damaging their financial profile while trying to keep pace with CVS and WBA.

Figure 4: Revolver Draws



Source: Company Filings, MFIF Analysis

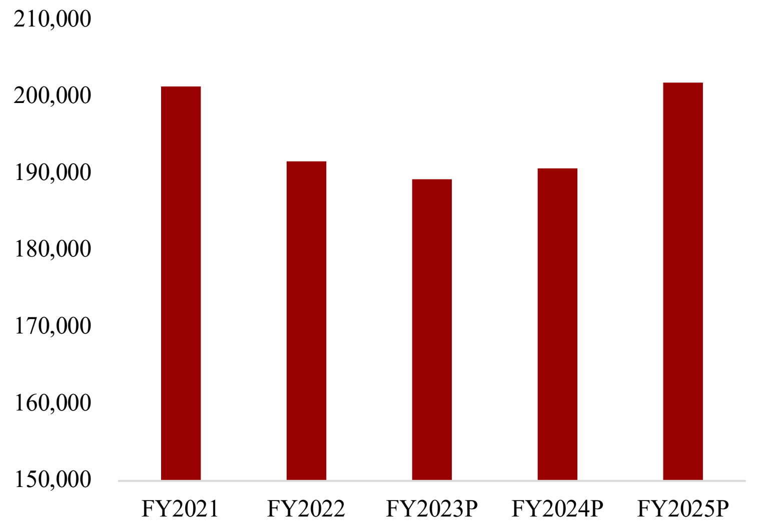
Figure 5: Comparable Company Analysis

Comps ($ mm)	RAD	CVS	WBA	WMT
Market Cap	307	132,408	35,362	417,178
Debt	32,227	71,072	36,413	65,380
Cash	47	19,989	2,472	11,587
EV	32,487	183,491	69,303	470,971
LTM Revenue	24,210	315,225	132,703	600,112
LTM Adj. EBITDA	1,062	20,134	8,899	31,702
LTM FCF	-323	19,498	2,165	7,009
CapEx	211	2,636	1,734	16,579
Interest Expense	195	2,343	399	1,416
Debt/EBITDA	9.86x	3.53x	4.09x	2.06x
Debt/FCF	-99.83x	3.65x	16.82x	9.33x
Coverage	5.46x	8.59x	22.30x	22.39x
Individual Securities	**RAD**	**CVS**	**WBA**	**WMT**
Rating	CC/B3	BBB/Baa2	BBB/Baa2	AA/Aa2
Maturity	7/1/25	7/20/25	1/20/25	9/9/25
Coupon	7.500	3.875	3.600	3.900
Price	74.0145	98.662	95.3345	99.1225
YTW	21.12%	4.42%	5.28%	4.24%
OAS	1,689	24.3	189.7	20.5

Source: Bloomberg Terminal, MFIF Analysis

Worsening debt situation highlights poor credit profile

Figure 6: Interest Expense



Source: Company Filings, MFIF Analysis

Rite Aid has continuously needed to tap into debt markets, steadily increasing debt levels over the past 10 quarters. The company's revolver and FILO term loan are trading at a small discount to par, with all RAD's outstanding bonds trading at much steeper discounts. The revolver is consistently relied upon to mitigate negative FCF. As of 2Q23, the revolver had an undrawn balance of ~$1.3B, which based upon MFIF analysis ~$816M of will be exhausted by the end of 4Q25P, or within the next 10 quarters. Current maintenance of the debt profile is unsustainable for Rite Aid, resulting in a tender offer on the 2025 7.5% notes. The exchange, which would see RAD repurchase $200M of the ~$480M outstanding notes, would result in creditors being paid out up to $750 per $1,000 of notes. Despite needing ⅔ approval, the notes are likely to tender because if not, creditors will be stripped of all collateral and notes will become unsecured. If tendered, the offer allows RAD to modify indentures on the note and likely restructure or eliminate the collateral package and release covenants. While the tender offer is not an indicator of default risk in the short term (NTM), it reflects RAD's inability to maintain current levels and manage them into the future. The 2025 notes represent the smallest tranche of secured debt in RAD's capital structure, which is likely why they were subject to the tender offer. Rite Aid stated when the tender offer was announced that the "refinancing will improve debt maturity profile and result in decreased interest expense". This is only a short-term solution, as FY2023 interest expense is only ~2.3M lower than FY2022 based on MFIF analysis, and interest expense will exceed FY2022 by FY2025 because of necessary drawdowns on the company's revolver to maintain a positive cash balance. Interest expense would increase even further on the back of more HY issuances. The tender offer sets precedent for RAD attempting to negotiate with creditors on further distressed debt exchanges because they are unable to fully fulfill their obligations, potentially resulting in the company filing bankruptcy.

Recovery Analysis

With worsening financial performance and the inability to leverage high yield debt markets to fund acquisitions and finance operations without putting an even greater strain on the company's already weak credit profile, RAD could be faced with chapter 7 bankruptcy or liquidation. On the back of the tender offer, Fitch Ratings downgraded RAD's Long-Term Issuer Default Rating (IDR) to "C" from "B-". The ratings agency views the offer as a Distressed Debt Exchange (DDE) that, upon completion, would see their IDR to "RD", or restricted default. Despite company performance, in the event of a bankruptcy RAD could yield substantial return through a recovery analysis because of substantial asset base. Three asset classes main asset classes account for ~75% of RAD's book asset value as of 2Q23: accounts receivable, inventories, and operating lease right-of-use assets. While 100% recovery of accounts receivable is assumed, recovering full value of the other two assets is more difficult. Operating lease right-of-use assets, which is the lessee, or RAD's, right to use an asset over the life of a lease, is difficult to predict. Because of the variability of lease length's and how they could be utilized in the event of RAD shutting down operations, a 25% recovery was assumed. While inventories would provide considerable value in the event of a liquidation, given the scale of RAD's operations flooding the market for their inventory would likely diminish its value, resulting in these goods being sold at a discount. Because of the fire-sale nature of the liquidation of RAD's inventories, a 70% recovery of the asset class was assumed. Furthermore, it should be noted that as Rite Aid's worsening situation drags on, their asset base could continue to diminish, thus lowering recovery value in the event of liquidation. Since 1Q21, total assets have fallen from over $1B from $9.52B to ~$8.37B, which also led to the conservative estimates for several of the assets included in the recovery model. MFIF projects assets to continue to diminish, eroding another ~$302M by YE2025. Based on these assumptions 1st lien secured debt, the company's revolver and FILO TL, are fully recovered. The second tranche of secured debt, the 2025 and 2026 notes, are each recovered 83.28% on a pari-passu basis, leaving none of the unguaranteed debt to be recovered. **Given the current price of RAD's 2025 senior secured notes of $74.02, in line with the purchase price of the tender offer, an 83.28% recovery of the notes would yield an annualized return of 13.46% and 32.44% total return.**

Figure 7: Recovery Model

Recovery Analysis			
Asset	**Book Value**	**% recovery**	**Amount Recovered**
Cash and cash equivalents	46,808	100.00%	46,808
Accounts receivable, net	1,564,388	100.00%	1,564,388
Inventories, net of LIFO reserve	2,026,216	70.00%	1,418,351
Prepaid expenses and other current assets	103,452	10.00%	10,345
Property, plant, and equipment, net			
Land	83,485	85.00%	70,962
Buildings	314,143	85.00%	267,022
Leasehold improvements	181,740	10.00%	18,174
Equipment	181,740	60.00%	109,044
Software	92,139	50.00%	46,070
Construction in progress	97,715	50.00%	48,858
Operating lease right-of-use assets	2,679,500	25.00%	669,875
Goodwill	626,936	0.00%	0
Other intangibles, net	268,040	5.00%	13,402
Deferred tax assets	13,938	0.00%	0
Other assets	86,885	50.00%	43,443
Liquidation Recovery	**8,367,125**	**51.71%**	**4,326,741**
Recovery by Tranche			
Super Secured Claims			
Fees	26	100.00%	26
Accounts Payable	1,511,673	100.00%	1,511,673
Total Super Secured Recovery	**1,511,699**	**100.00%**	**1,511,699**
First Lien Secured Claims			
Credit Revolving Facility	1,370,026	100.00%	1,370,026
FILO Term Loan	347,921	100.00%	347,921
Total First Lien Secured Recovery	**1,717,947**	**100.00%**	**1,717,947**
Second Lien Secured Claims			
7.5% 2025 senior secured notes	480,368	83.28%	400,029
8.0% 2026 senior secured notes	837,060	83.28%	697,066
Total Second Lien Secured Recovery	1,317,428	83.28%	1,097,095
Unguaranteed Debt Claims			
7.7% 2027 unsecured notes	185,240	0.00%	0
8.875% 2028 fixed rate senior unsecured notes	2,040	0.00%	0
Total Unguarnteed Debt Recovery	**187,280**	**0.00%**	**0**
Total Recovery	**9,468,708**	**91.39%**	**8,653,481**

Figure 8: Summary Model

Summary Model ($ in thousands)	FY2021	FY2022	FY2023P	FY2024P	FY2025P
Income Statement					
Revenue	24,043,240	24,568,255	23,722,044	23,279,904	22,978,570
% growth (decrease)		2.2%	-3.4%	-1.9%	-1.3%
Operating Expenses					
Cost of revenues	19,338,918	19,461,760	19,009,542	18,623,923	18,382,856
Selling, general, & administrative	4,657,185	5,033,876	4,831,792	4,772,380	4,710,607
Total operating expenses	23,996,103	24,495,636	23,841,334	23,396,303	23,093,463
Operating Income (Loss)	47,137	72,619	(119,290)	(116,400)	(114,893)
Interest expense (benefit)	201,388.0	191,601.0	189,302.3	190,685.2	201,875.0
Total other expenses	1,040,964	534,729	644,755	881,161	1,002,586
Income (loss) before income tax expense (benefit)	(120,227)	(542,258)	(610,349)	(379,350)	(323,557)
Income tax (benefit)	(20,157.0)	(3,780.0)	20,993.9	11,380.5	9,706.7
Net income (Loss)	(100,070)	(538,478)	(631,343)	(390,731)	(333,264)
Balance Sheet					
Cash and cash equivalents	160,902	39,721	100,000	100,000	100,000
Accounts Receivable	1,462,441	1,343,496	1,561,246	1,531,946	1,517,520
Inventories, net of LIFO reserve	1,864,890	1,959,389	2,011,189	1,973,445	1,954,862
Prepaid expenses and other current assets	106,941	106,749	103,452	103,452	103,452
Total current assets	3,595,174	3,449,355	3,775,887	3,708,843	3,675,834
PP&E	1,080,499	989,167	922,011	862,587	802,520
Operating lease right-of-use assets	3,064,077	2,813,535	2,674,118	2,623,933	2,599,224
Goodwill	1,108,136	879,136	626,936	626,936	626,936
Other intangibles, net	340,519	291,196	267,502	262,481	260,010
Other assets	146,999	106,614	100,823	100,823	100,823
Total Assets	9,335,404	8,529,003	8,367,277	8,185,603	8,065,347
Current Liabilities	2,602,946	2,933,088	2,806,091	2,764,268	2,743,675
Long-term debt	3,063,087	2,732,986	3,425,344	3,676,225	3,909,824
Long-term operating lease liabilities	2,829,293	2,597,090	2,496,476	2,496,476	2,496,476
Other liabilities	224,924	166,806	165,625	165,625	165,625
Total Liabiltiies	8,720,250	8,429,970	8,893,536	9,102,594	9,315,601
Statement of Cash Flows					
Cash from Operating Activities	105,179	379,272	(494,701)	(41,362)	(26,792)
Capital Expenditures	(195,141)	(194,090)	(228,501)	(209,519)	(206,807)
Cash from Investing Activities	(109,335)	(134,073)	(156,868)	(209,519)	(206,807)
Cash from Financing Activities	(65,243)	(366,380)	711,847	250,881	233,599
Free Cash Flow	300,320	573,362	(266,200)	168,157	180,015
EBITDA Reconciliation					
Net Income	(100,070)	(538,478)	(631,343)	(390,731)	(333,264)
(+) interest expense	201,388	191,601	189,302	190,685	201,875
(+) taxes	(20,157)	(3,780)	20,994	11,381	9,707
(+) depreciation & amortization	327,124	295,686	273,846	268,943	266,873
EBITDA	408,285	(54,971)	(147,200)	80,278	145,191
Credit Metrics					
Debt	2,602,946	2,933,088	2,806,091	2,764,268	2,743,675
Adj. EBITDA Projections	437,665	505,905	372,000	447,278	512,191
Debt/EBITDA	5.95x	5.80x	7.54x	6.18x	5.36x
EBITDA/Interest	2.17x	2.64x	1.97x	2.35x	2.54x