**Report concerning Sainsbury's bid for Argos**

## 1. Introduction

Sainsbury's PLC ("Sainsbury's") recently acquired Home Retail Group and crucially its subsidiary, Argos. It appears to have been a commercially ambitious move by Sainsbury's, which is clearly attempting to dethrone companies such as John Lewis and Marks and Spencer from the top of the non-food industry. Furthermore, it represents an attempt to close the gap on the market share of Tesco for both its grocery and non-grocery sectors. Whilst a commercially viable move, it also poses risks such as the competition faced by digital markets such as Amazon and the inevitably large cost of the acquisition and overheads with no real guarantee of commercial success. This report will explain and analyse how the bid was made and whether it was the right way of acquiring Home Retail Group. Additionally, the risks and motives of the acquisition will be considered with a specific focus on the commercial considerations that would have to be made prior to and following the merger. Finally, it will determine whether or not the acquisition is indicative of a commercial success through careful consideration of these factors and how it will benefit or harm the stakeholders to the deal.

## 2. The acquisition

### 2.1 Outline of the bid

The cost of the takeover amounted to a total of £1.4billion and the breakdown of the acquisition shows how complicated the deal was. The base offer valued the company at £1.2bn, but additional fees raised the price by £200m. Included in these fees were 2.8p per share "to compensate Home Retail shareholders for the final dividend they would have received without the deal, and a 25p share cash return from the sale of Homebase"[1]. The deal represented a total payment of around 173.2p per share[2]. Clifford Chance acted for Sainsbury's and Linklaters advised Home Retail.

[1] Jon Yeomans, and Ashley Armstrong (2016). Sainsbury's returns with £1.3bn offer for Argos, The Telegraph, London.
[2] Luke Tugby (2016). Timeline: How Sainsbury's won the race for Argos, Retail-Week, London.

### 2.2 Newco and the scheme of arrangement

The takeover was completed using a scheme of arrangement whereby Home Retail agreed that its shares would be transferred to Sainsbury's[3]. To do this, the companies took advantage of a legal exception to the rule (section 641(2B) of the Companies Act 2006) concerning schemes of arrangement by cancellation by setting up a new parent company for Home Retail, Newco[4]. The exception to the general principle that a company may not reduce its share capital in this way is outlined as follows in the act:

(2B)

> (a)the company is to have a new parent undertaking,
>
> (b)all or substantially all of the members of the company become members of the parent undertaking, and
>
> (c)the members of the company are to hold proportions of the equity share capital of the parent undertaking in the same or substantially the same proportions as they hold the equity share capital of the company.

In a cancellation scheme, the shares in the target company (Home Retail) are cancelled, "creating a reserve of capital which is then capitalised and applied in paying up new shares which are issued and allotted to the bidder" (Sainsbury's) [5]. Newco, therefore, paid out £200m to the existing shareholders for the cancellation of its shares, so that Newco would retain the entire shareholding. Following this, Sainsbury's acquired Newco's shares by way of a takeover offer, offering 55p cash and 0.321 of Sainsbury's shares, as well as paying stamp duty on the transfer of the Newco shares.

Using this exception is controversial, as it reduced the stamp duty burden on the transfer of Home Retail's shares from the main transaction. Moreover, the section 641(2B) exception was used for a purpose for which it was not intended. Cancellation schemes are typically not permitted for the sole purpose of reducing the stamp duty tax payable, but by employing this exception (which was in fact court approved), they were able to do just that[6].

[3] Natalie Hellio (2016). A deal in focus: Sainsbury's takeover of Argos, Lawcareers, London.
[4] Any statutory references are to the Companies Act 2006 unless otherwise stated.
[5] Natalie Hellio (2016). A deal in focus: Sainsbury's takeover of Argos, Lawcareers, London.
[6] CMA decision on acquisition by J Sainsbury Plc of Home Retail Group Plc by Practical Law Competition

The transaction was structured in this way as Home Retail did not have enough share capital and premium to pay £200m to its shareholders that could be regarded as a capital distribution. Establishing a new parent company facilitated a way to do this. Furthermore, it means that Sainsbury's was able to pay a lower purchase price for the company as the £200m of capital reserves would no longer appear on Home Retail's balance sheet and therefore would not be included in the company's valuation. Were it to be included, the transaction would have been graded as a Class 1 transaction as defined in the Takeover Code[7]. The consequences of this would have been the requirement of Sainsbury's shareholder approval to agree to the acquisition and by avoiding having to do this, significant time was saved.

### 2.3 Additional details and costs

The merger is expected to cost an additional £140m over the next three years, with a further £140m to be spent on the restructuring of existing Sainsbury's stores to incorporate Argos outlets[8]. In addition, current Argos stores are likely to disappear from the high street as most will merge with existing Sainsbury's stores, although the cost of this is possibly included in the restructuring price. The leaseholds of as many as 40% of the 840 Argos shops in the UK expire within the next five years, making it more straightforward and cheaper to close those stores[9].

Sainsbury's forecasts annual cost savings of around £120m by removing Argos stores from high streets and replacing them with in-store alternatives. The reduction in maintenance and rent for the stores will result in increased profitability forecasts with the group targeting double-digit profit growth by the 3$^{rd}$ year of the merger[10].

### 2.4 John Rogers' analysis

Sainsbury's CEO, John Rogers, claims that the purchase of Argos was "essentially… £250m"[11]. That is obviously significantly less money than the aforementioned £1.4bn, but

[7] The Takeover Code
[8] Jon Yeomans, and Ashley Armstrong (2016). Sainsbury's returns with £1.3bn offer for Argos, The Telegraph, London.
[9] Jennifer Faull (2016). 5 things you need to know about Sainsbury's takeover bid for Argos, TheDrum, London.
[10] Jon Yeomans, and Ashley Armstrong (2016). Sainsbury's returns with £1.3bn offer for Argos, The Telegraph, London.
[11] ibid

deeper analysis into how Sainsbury's structured the deal highlights that the total price may be deceptive.

John Rogers immediately discounts the £200m paid out to Home Retail shareholders by Newco as not included in the price, making the cost now an effective £1.2bn. Sainsbury's then transferred Argos's loan book, worth an additional £600m in debtors, to its own bank and "is using its bank customer deposits to finance the loan book"[12].

Further to this asset of £600m is the capital reserves of Home Retail which appear as £250m on the balance sheet. Sainsbury's will, however, be topping up its "enlarged financial arm with a £100m cash injection"[13] in order to follow Core Tier-1 capital requirements[14], leaving Sainsbury's with £750m cash on its balance sheet[15]. The cash element of the takeover cost £440m, leaving £310m for Sainsbury's to pay down its debt. Sainsbury's also believes it can generate "£160m [in] potential synergies"[16], largely from the closure and sale of Argos high-street stores, and therefore reduced running costs, resulting in a significantly lowered purchase price for Home Retail and Argos. John Rogers may have been optimistic in stating that it cost £250m, but the reality is that it did indeed effectively cost significantly less than the quoted £1.4bn.

### 2.5 Summary

The structure of the bid represents a success for the companies and its shareholders as it resulted in a cost-effective and swift transition. The incorporation of Argos outlets into existing Sainsbury's stores represents a large financial undertaking, but these costs have been accounted for and will seem relatively cheap in comparison to eventual profit forecasts.

[12] Jon Yeomans, and Ashley Armstrong (2016). Sainsbury's returns with £1.3bn offer for Argos, The Telegraph, London.
[13] ibid
[14] Basle Capital Accord (1998). International Convergence of Capital Management and Capital Standards.
[15] Calculated as £600m debtors + £250m capital reserves - £100 cash injection.
[16] Financial Times (2016). Home Retail accepts Sainsbury's £1.4bn takeover bid, The Financial Times, London.

## 3. Motives for acquisition

### 3.1 Relatively low cost of the acquisition

As mentioned above, the effective cost of the acquisition is significantly lower than it appears. The fact that Sainsbury's were able to purchase Home Retail for a relatively low price by offsetting it against existing assets would be a natural motive. The comparison of the price as being “as cheap as a Fisher Price toy set” is an indication of how cheaply speculators believe Sainsbury's have managed to purchase Argos for[17].

### 3.2 Revenue increase

CEO of J Sainsbury plc (the parent company of Sainsbury’s) Mike Coupe said that the new combined company “could bake a bigger cake than the two companies could bake on their own”[18]. This is reference to the increased revenue the company can expect while also diminishing the running costs of the company. As previously mentioned, by closing existing Argos storefronts and relocating them to within Sainsbury’s stores, it will be paying significantly less rent and utilities and therefore will be able to increase its potential profitability. The new company’s belief that double-digit profit growth is attainable within three years highlights its ambition to increase revenue significantly and increase its market share against competing companies.

### 3.3 Greater UK grocery market share

Sainsbury's is currently the second largest supermarket service in the UK with 15.9% market share in comparison to Tesco's vastly superior 27.8%[19]. Tesco also operates its own non-food industry with Tesco Direct, allowing consumers to order a variety of products online that would not ordinarily be available in store. Sainsbury's will undoubtedly be hoping that the acquisition of Home Retail will give them a greater opportunity to compete with Tesco, both in the food industry and non-food industry. Competition is healthy for consumers and it is therefore possible that customers who would ordinarily shop at Tesco could opt for a change if Sainsbury's are able to attract them after the acquisition and incorporation into

[17] Jon Yeomans, and Ashley Armstrong (2016). Sainsbury's returns with £1.3bn offer for Argos, The Telegraph, London.
[18] Jennifer Faull (2016). 5 things you need to know about Sainsbury’s takeover bid for Argos, TheDrum, London.
[19] Kantar Worldpanel UK supermarket market share

the stores is finalised. This would allow Sainsbury's to reclaim some of the market share that Tesco boasts and to fully outshine other supermarket competition.

### 3.4 Competition with other non-food sellers

Sainsbury's insists that its main competitors are Marks & Spencer and John Lewis rather than online titan Amazon[20]. Marks & Spencer are reportedly struggling in the market[21], with key figures leaving and sales figures declining, whereas John Lewis (and its partnership with Waitrose) is increasing its digital presence and has seen a rise in sales as a result[22]. Mike Coupe has been keen to develop Sainsbury's digital strategy – so that the competition does not outshine it – since becoming CEO in 2014 and this deal will help facilitate that. Argos invested £10m into improving its delivery methods to offer same-day delivery last year and has also been replacing its iconic catalogues with in-store tablets for a more modern approach[23].

John Lewis is often seen by consumers as a premium store in comparison to Argos, and there is an argument to be made that Argos is not truly in competition with them. However, the period of austerity imposed by the Government – and indeed the damage to the economy inflicted by Brexit – could result in consumers looking for a cheaper alternative. Lidl and Aldi have already prospered from this desire for discount stores as a result of the austerity imposed on customers by the Government and, therefore, Argos may be able to use this to compete with John Lewis[24].

Coupe stated that 40% of the UK population shop at both Sainsbury's and Argos[25]. The merger and incorporation of Argos outlets into Sainsbury's stores should, therefore, drive business even further and incite potential new customers to shop at both. Furthermore, Coupe claims that the combined entity's non-food business is valued at £6bn which is

[20] Jennifer Faull (2016). 5 things you need to know about Sainsbury's takeover bid for Argos, TheDrum, London.
[21] John Glendary (2016). Marks & Spencer's Marc Bolland to depart in wake of dismal Christmas sales, TheDrum, London.
[22] Jennifer Faull (2016). Online drives bulk of John Lewis' Christmas sales but Waitrose disappoints, TheDrum, London.
[23] Natalie Mortimer (2015). Argos invests £10m in same-day delivery despite 'uncertain' Black Friday shopping habits, TheDrum, London.
[24] Sarah Butler (2017). Strong sales growth at Aldi and Lidl takes their market share to 12%, The Guardian, London.
[25] Jennifer Faull (2016). 5 things you need to know about Sainsbury's takeover bid for Argos, TheDrum, London.

greater than John Lewis and Marks & Spencer and, although value does not necessarily translate to success, it should ultimately prove to be very successful.

## 4. Risks associated with the acquisition

### 4.1 Overvaluation of the acquisition

If the due diligence undertaken was unsatisfactory and failed to locate potential risks, it is possible that the purchase price of Home Retail was too high. This would represent a poor investment by Sainsbury's and would result in a fall in shareholder confidence. This would lead to a fall in the share value, or at least not as much of an increase as Sainsbury's was anticipating prior to the acquisition. Furthermore, it could be the case that the dilution of shareholders' shares as a result of the acquisition triggers a flash sale by the shareholders, leaving Sainsbury's with significantly less equity than it was hoping for. It is unlikely that this risk is a valid assessment of the acquisition, however, as both companies have had highly reputable law firms acting on their behalf and Sainsbury's remains a behemothic company, meaning that shareholders are unlikely to react with such volatility because of an acquisition.

### 4.2 The danger of online markets

Analysts initially expected this acquisition to be Sainsbury's attempt to compete with online market giants such as Amazon, but Mike Coupe insisted that this was not the case. He argued that it would create a unique business in the UK, "with over 2,000 shops which Amazon does not have" and that Marks & Spencer and John Lewis would become its main non-food competition[26]. However, it would be naïve to suggest that Amazon's business does not directly compete with Argos, particularly with the convenience and speed with which Amazon delivers. The emergence of online marketplaces poses somewhat of a risk to offline non-food retailers like Argos, as they are typically more consumer friendly, are less limited in their stock, and can also be more affordable. Their running costs can also be lower, as they often are not paying for the maintenance of stores – instead delivering directly from

[26] Jon Yeomans, and Ashley Armstrong (2016). Sainsbury's returns with £1.3bn offer for Argos, The Telegraph, London.

their warehouses. Argos does have an online system, but the focus of its business model is undeniably its storefronts.

### 4.3 The dwindling level of demand

An extension of the competition with online markets is the level of demand. As the digitalisation of shopping tightens its grip on consumer wallets, the requirement for physical shops may diminish. The modernisation process which Argos is currently undergoing may not be enough to ensure its long-term success and prosperity if the online market continues to be so prevalent. If Argos is to succeed, therefore, it may be a wiser investment to minimise maintenance costs completely by converting it into a purely online platform as opposed to incorporating it into Sainsbury's stores. However, this could be very expensive and result in legal battles with former employees if a huge number of jobs are removed in favour of profit.

### 4.4 Incorporation into existing stores

The cost associated with the closure and sale of its current stores and the incorporation of the business into existing Sainsbury's stores will inevitably have an impact on the finances of the company. Further to the previous point about the demand for physical stores in a digital world, it may not be very cost efficient and could actually result in a loss of market share rather than the gain it is looking to achieve.

Furthermore, a share acquisition of a company poses potential issues with the rights of employees. The Transfer of Undertakings (Protection of Employment) Regulations 2006 ("TUPE") protects employees in the event of an acquisition by ensuring the transfer of its employment to the new employer. Sainsbury's will be subject to TUPE for the purposes of this acquisition and will have to be mindful of the adverse effects that closing storefronts may have on the jobs of employees.

### 4.5 Negotiation of price with manufacturers

The acquisition of Home Retail is a statement of intent to manufacturers and suppliers that Sainsbury's wishes to expand and that it has the financial power to do so. Seeking opportunity to increase revenue, manufacturers and suppliers for Sainsbury's may seek to increase its prices, which could result in difficulties. If contracts with manufacturers and suppliers are soon due for review, it may be difficult to harmonise prices with them and negotiations may have to take place that would not favour Sainsbury’s. It is unlikely that this is a large risk, as Sainsbury’s will naturally be a vital client to any suppliers and manufacturers and, therefore, they are unlikely to want to encourage Sainsbury’s to find new companies to work with.

### 4.6 Brexit and austerity

Earlier, the effect that the desire to save had on Lidl and Aldi and the positives that brought was mentioned, and how it could benefit Sainsbury’s post-acquisition. However, unlike supermarkets, Argos is not renowned for its daily essentials and may suffer the adverse effects of austerity. If consumers opt not only to save, but to not spend at all on the kinds of wares available at Argos, profit levels could slip. This effect could be felt particularly because of the result of the UK referendum to leave the European Union, the recent rise in inflation and the current low interest rates.

## 5. Conclusion

Ultimately, it would be difficult to argue against this being a commercially sensible deal for both parties. With the financial resources that Sainsbury’s can offer, the advancement and further development of Home Retail and Argos are in safe hands. A key policy of Home Retail over the past few years has been versatility, adaptation and modernisation. Sainsbury’s can facilitate this whilst also broadening the client pool and assuring the profitability of the companies.

For Sainsbury’s, this represents commercial success in a different way. Sainsbury’s will be able to use this acquisition as a springboard to claim some of the national grocery market share from Tesco and grow further. Additionally, its foray into the non-food business enables them to become more competitive in other sectors. Acquiring Argos means acquiring an already renowned and successful business and, therefore, Sainsbury’s will not necessarily have to invest large amounts of money or time to grow the brand, as it is already nationally recognised and revered.

A further advantage for Sainsbury’s is the relatively low price it has managed to acquire Argos for. There are arguable financial risks that could pose a threat to that initial low cost, such as the cost of opening outlets in stores, closing existing stores and the renegotiation of deals with suppliers. However, if initial predictions by the company are accurate, these will pose relatively few problems.

Overall, it appears that this was a very shrewd piece of business and a very commercially successful acquisition. Both companies should feel that they received a good deal – Sainsbury's financially and Home Retail because of the smoothness of the process and the fact that the brand will now be able to grow further under the guidance of one of the largest companies in the UK.

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