DUANE READE INC
Form 8-K
July 09, 2004

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 8-K

**CURRENT REPORT PURSUANT
TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934**

Date of Report (Date of Earliest Event Reported): July 9, 2004

DUANE READE INC.

(Exact Name of Registrant as Specified in its Charter)

Delaware

(State or Other Jurisdiction of Incorporation)

001-13843 (Commission File Number)	**04-3164702** (I.R.S. Employer Identification No.)
440 Ninth Avenue **New York, New York** (Address of Principal Executive Offices)	**10001** (Zip Code)

(212) 273-5700
(Registrant's Telephone Number, Including Area Code)

N/A
(Former Name or Former Address, if Changed Since Last Report)

Item 12. Results of Operations and Financial Condition.

The following information regarding Duane Reade Inc. ("we," "us" or the "Company") was provided to potential lenders on July 9, 2004 by the Company in connection with proposed financing transactions to be entered into by the Company in conjunction with its acquisition (the "Acquisition") by affiliates of Oak Hill Capital Partners, L.P. For more information regarding the Acquisition and related financing transactions (collectively, the "Transaction"), please see the Company's statement on Schedule 14A, dated June 30, 2004, and its statement on Schedule 13E-3, as amended to date, which have been filed electronically with the Securities and Exchange Commission.

1. Pro forma financial information

The unaudited pro forma financial data set forth below reflects adjustments to our consolidated historical financial data to give pro forma effect to the Transaction, including:

- the completion of the Acquisition;
- the $234.0 million cash equity contribution by the investor group led by Oak Hill Capital Partners, L.P.;
- the forfeiture by certain members of senior management of approximately $4.2 million of payments under existing contracts and our issuance of phantom stock to them;
- an additional $74.6 million of borrowings under our amended asset-based revolving loan facility;
- the borrowing of $155.0 million under our new senior term loan facility;
- the issuance of $195.0 million of senior subordinated debt;
- the repurchase of our outstanding 2.1478% senior convertible notes due 2022 for an aggregate purchase price of $201.0 million, plus the payment of $3.6 million of accrued but unpaid interest;
- the elimination of certain expenses associated with being an NYSE-listed company;
- the payment of an annual $1.25 million management fee, paid quarterly, to an affiliate of Oak Hill Capital Partners, L.P.; and
- the incurrence of approximately $53.1 million of transaction expenses, including certain payments to members of our management.

The unaudited pro forma statements of operations for the 13 weeks and 12 months ended March 27, 2004 and the year ended December 27, 2003 give pro forma effect to each of the above items as if the Transaction had occurred as of the beginning of the relevant period. The unaudited pro forma balance sheet at March 27, 2004 gives pro forma effect to each of the above items as if it had occurred on that date.

The pro forma adjustments are based on preliminary estimates, available information and certain assumptions that we believe are reasonable and may be revised as additional information becomes available. The pro forma adjustments and certain assumptions are described in the accompanying notes.

The unaudited pro forma financial information set forth below should be read in conjunction with our historical financial information and "Management's Discussion and Analysis of Financial Condition and Results of Operations" which are included in documents we have filed with the SEC.

Unaudited Pro Forma Condensed Consolidated Balance Sheet
At March 27, 2004
(in thousands)

	Actual	Pro Forma Adjustments	Pro Forma
Current assets			
Cash and equivalents	$ 1,285	$	$ 1,285
Accounts receivable, net	59,124		59,124
Inventories	250,029		250,029
Prepaid expenses and other current assets	17,751		17,751
Deferred income taxes	7,923		7,923
Total current assets	336,112		336,112
Property, plant and equipment, net	191,055		191,055
Other assets			
Goodwill	161,625	1,339 (1)	162,964
Deferred income taxes	4,940		4,940
Other assets	99,651	12,230 (2) 102,822 (3)	214,703
Total assets	$ 793,383	$ 116,391	$ 909,774
Current liabilities			
Current maturities of capital lease obligations	$ 431	$	$ 431
Accounts payable	76,837		76,837
Accrued liabilities	34,563	(3,582)(4)	30,981
Total current liabilities	111,831	(3,582)	108,249
Long-term debt, excluding current maturities	276,470	223,530 (5)	500,000
Capital lease obligations	992		992
Deferred income taxes			
Other non-current liabilities	65,357	4,198 (6)	69,555
Total shareholder's equity	338,733	(107,755)(7)	230,978
Total liabilities and shareholder's equity	$ 793,383	$ 116,391	$ 909,774

The accompanying notes are an integral part of the
unaudited pro forma condensed consolidated financial statements.

Notes to the Unaudited Pro Forma Condensed Consolidated Balance Sheet
(in thousands)

(1)

Records the excess of the purchase price over the fair value of the net assets acquired, less the write-off of goodwill existing prior to the Acquisition.

(2)

Records the deferred financing costs capitalized in connection with the financing for the Acquisition, net of the write-off of deferred financing costs related to the early repayment of our senior convertible notes.

(3)

Records the write-up of identifiable intangible assets for the change in ownership of Duane Reade Inc. Our pro forma other assets are as follows:

Lease acquisition costs	$	100,000
Customer lists		65,000
Executive split dollar life insurance policies		17,088
Software and systems development costs		9,305
Deferred financing costs		18,675
Security deposits		2,220
Other		2,415
Total	$	214,703

(4)

Records the payment of accrued interest on the retirement of our indebtedness outstanding prior to the Acquisition.

(5)

To record the repayment of our existing indebtedness and the incurrence of new indebtedness in connection with the Acquisition. The following is a summary of our pro forma indebtedness:

Revolving credit facility	$	150,000
New senior term loan facility		155,000
Senior subordinated debt		195,000
Total	$	500,000

(6)

Records the liability for phantom stock issued to management.

(7)

Records the new equity investment of $234,000, net of related expenses and the retirement of our existing equity in connection with the Acquisition.

Unaudited Pro Forma Condensed Consolidated Statement of Operations
For the thirteen weeks ended March 27, 2004
(in thousands)

	Actual	Pro Forma Adjustments	Pro Forma
Net sales	$ 349,550	$	$ 349,550
Cost of Sales	273,785		273,785
Gross profit	75,765		75,765
Selling, general and administrative expenses	58,643	(422)(1)	58,221
Labor contingency expense	1,100		1,100
Transaction expenses	1,102		1,102
Management fees		313 (2)	313
Depreciation and amortization	9,066	2,840 (3)	11,906
Store pre-opening expenses	157		157
Operating profit	5,697	(2,731)	2,966
Interest expense, net	3,437	5,053 (4) 300 (5)	8,790
Income (loss) before income taxes	2,260	(8,084)	(5,824)
Income tax expense (benefit)	904	(3,593)(7)	(2,689)
Net income (loss)	$ 1,356	$ (4,491)	$ (3,135)

The accompanying notes are an integral part of the
unaudited pro forma condensed consolidated financial statements.

Unaudited Pro Forma Condensed Consolidated Statement of Operations
For the year ended December 27, 2003
(in thousands)

	Actual	Pro Forma Adjustments	Pro Forma
Net sales	$ 1,383,828		$ 1,383,828
Cost of Sales	1,087,092		1,087,092
Gross profit	296,736		296,736
Selling, general and administrative expenses	227,910	(1,344)(1)	226,566
Labor contingency expense	12,600		12,600
Transaction expenses	644		644
Management fees		1,250 (2)	1,250
Depreciation and amortization	32,335	10,519 (3)	42,854
Store pre-opening expenses	1,063		1,063
Operating profit	22,184	(10,425)	11,759
Interest expense, net	14,117	20,069 (4) 1,485 (5)	35,671
Debt extinguishment	812	(812)(6)	
Income (loss) before income taxes	7,255	(31,168)	(23,913)
Income tax expense (benefit)	2,181	(13,854)(7)	(11,673)
Net income (loss)	$ 5,074	$ (17,314)	$ (12,240)

The accompanying notes are an integral part of the
unaudited pro forma condensed consolidated financial statements.

Unaudited Pro Forma Condensed Consolidated Statement of Operations
For the twelve months ended March 27, 2004
(in thousands)

	Actual	Pro Forma Adjustments	Pro Forma
Net sales	$ 1,399,756	$	$ 1,399,756
Cost of Sales	1,097,444		1,097,444
Gross profit	302,312		302,312
Selling, general and administrative expenses	232,979	(1,539)(1)	231,440
Labor contingency expense	13,700		13,700
Transaction expenses	1,746		1,746
Management fees		1,250 (2)	1,250
Depreciation and amortization	33,844	10,897 (3)	44,741
Store pre-opening expenses	804		804
Operating profit	19,239	(10,608)	8,631
Interest expense, net	14,037	20,171 (4)	35,861
		1,653 (5)	
Debt extinguishment	707	(707)(6)	
Income (loss) before income taxes	4,495	(31,725)	(27,230)
Income tax expense (benefit)	1,177	(14,102)(7)	(12,925)
Net income (loss)	$ 3,318	$ (17,623)	$ (14,305)

The accompanying notes are an integral part of the
unaudited pro forma condensed consolidated financial statements.

Notes to the Unaudited Pro Forma Condensed Consolidated Statements of Operations
(in thousands)

(1) Records the elimination of expenses associated with having listed equity securities.

(2) Records a management fee payable to Oak Hill.

(3) Records pro forma amortization expense relating to identifiable intangible assets with useful lives ranging from 7 to 10 years.

(4) Records pro forma interest expense associated with the issuance of senior subordinated debt, the new senior term loan and additional borrowings under the amended asset-based revolving loan facility, and the elimination of interest expense on our senior convertible notes. A change in the overall interest rate of one-eighth percent would affect annual interest expense by approximately $0.6 million.

(5) Records the pro forma amortization of deferred financing fees.

(6) Records the reversal of debt extinguishment expense for debt retired as part of the Acquisition.

(7) Records the adjustment to the tax provision resulting from the pro forma adjustments. The calculation contemplates a federal statutory tax rate of 35.0%, a combined New York State and New York City statutory tax rate (net of the federal benefit) of 10.6%, and an overall effective tax rate of 44.4%.

2. The following are certain items affecting net income for the 12 months ended March 27, 2004:

(a) The Company uses the "Last-In, First-Out" method of inventory valuation, which resulted in a non-cash increase in cost of sales of $0.4 million during the 12 months ended March 27, 2004.

(b) For the 12 month period ending March 27, 2004, we incurred costs associated with certain litigation matters. We estimate that these non-recurring legal and professional fees represented approximately $4.5 million of our total legal and professional fees of $8.3 million during the period. The non-recurring litigation matters involve:

- a claim for recovery of business interruption losses sustained as a result of the September 11 terrorist attacks and the destruction of two store locations at the World Trade Center. For the twelve month period ending March 27, 2004, the World Trade Center litigation was the largest of our non-recurring legal and professional fee items, at approximately $2.0 million;
- claims by and cross-claims against a former supplier of pharmaceutical merchandise to us;
- a claim brought against us by our delivery drivers, which as of March 27, 2004 had been substantially resolved, except as to the issue of legal fees to be paid to plantiffs' counsel;
- a dispute involving a real estate renovation at a landmark location; and
- various collective bargaining claims and other state and federal claims involving a labor union.

(c) We incurred losses as a result of the regional power interruption in the Northeastern United States during August 2003. The majority of these losses (approximately $1.0 million) was a result of the lost sales and margin that resulted from our temporary inability to operate a majority of our store locations. We also incurred inventory losses of approximately $0.2 million and other minor expenses as a result of the blackout, including incremental labor costs.

(d) In the third quarter of 2003, we initiated the implementation of a new shelf labeling program in our stores. The new shelf labeling system uses in-store printers and hand-held scanning devices to identify and print shelf labels for all merchandise in a store rather than individually pricing every item. The implementation cost for this new shelf labeling program was approximately $1.0 million which consists mainly of store labor costs associated with initial implementation. The shelf labeling program has provided us with savings from the reduced labor costs at the stores since the employees will no longer have to individually item-price the products. Had this program been in place in our stores for the entire twelve months ending March 27, 2004, we believe that store labor expenses over this period would have been reduced by approximately $2.7 million. Merchandise is now more accurately priced, with better visibility to customers.

(e) During the first quarter of 2004, we implemented a reduction of general and administrative staff in anticipation of the Acquisition, and the related responsibilities were reassigned to existing personnel. We incurred approximately $0.2 million of severance and related costs associated with this work force reduction during the first quarter of 2004. The payroll and related costs for the individuals affected by the reduction for the twelve months ended March 27, 2004 were approximately $2.4 million.

3.

The following is a reconciliation of net income and cash flow from operating activities to EBITDA for the 1999, 2000, 2001, 2002 and 2003 fiscal years, and the thirteen weeks ended March 29, 2003 and March 27, 2004.

	Fiscal Year					Thirteen Weeks Ended	
	1999	2000	2001	2002	2003	March 29, 2003	March 27, 2004
	(dollars in thousands)						
Net income	$ 40,691	$ 22,676	$ 24,730	$ 15,577	$ 5,074	$ 3,112	$ 1,356
Income tax (benefit) expense	(10,471)	15,610	16,107	14,127	2,181	1,908	904
Interest expense, net	29,348	35,935	27,623	17,925	14,117	3,517	3,437
Depreciation and amortization	21,415	23,151	26,634	26,935	32,335	7,557	9,066
Debt extinguishment			2,616	11,371	812	105	
Transaction expenses					644		1,102
Labor contingency expense					12,600		1,100
Other non-cash items (primarily deferred rent)	4,779	3,985	4,365	9,590	8,451	2,292	1,594
Insurance recovery				(9,378)			
Cumulative effect of accounting change, net				9,262			
EBITDA (LIFO Basis)	$ 85,762	$ 101,357	$ 102,075	$ 95,409	$ 76,214	$ 18,491	$ 18,559
Adjust LIFO (Income) Provision				(89)	360	150	240
EBITDA	$ 85,762	$ 101,357	$ 102,075	$ 95,320	$ 76,574	$ 18,641	$ 18,799

	Fiscal Year					Thirteen Weeks Ended	
	1999	2000	2001	2002	2003	March 29, 2003	March 27, 2004
	(dollars in thousands)						
EBITDA	$ 85,762	$ 101,357	$ 102,075	$ 95,320	$ 76,574	$ 18,641	$ 18,799
Adjust LIFO Income (Expense)				89	(360)	(150)	(240)
EBITDA (LIFO Basis)	85,762	101,357	102,075	95,409	76,214	18,491	18,559
Depreciation and amortization(a)	(21,415)	(23,151)	(26,634)	(26,935)	(32,335)	(7,557)	(9,066)
Other non-cash items (primarily deferred rent)	(4,779)	(3,985)	(4,365)	(9,590)	(8,451)	(2,292)	(1,594)
Labor contingency expenses					(12,600)		(1,100)
Transaction expenses					(644)		(1,102)
Insurance recovery				9,378			
Debt extinguishment			(2,616)	(11,371)	(812)	(105)	
Interest expense	(29,348)	(35,935)	(27,623)	(17,925)	(14,117)	(3,517)	(3,437)
Income taxes	10,471	(15,610)	(16,107)	(14,127)	(2,181)	(1,908)	(904)
Cumulative effect of accounting change, net				(9,262)			
Net income	$ 40,691	$ 22,676	$ 24,730	$ 15,577	$ 5,074	$ 3,112	$ 1,356
Net income	$ 40,691	$ 22,676	$ 24,730	$ 15,577	$ 5,074	$ 3,112	$ 1,356
Adjustments to reconcile net income to Cash provided by operating activities:							
Depreciation and amortization(b)	22,827	24,878	28,098	28,836	34,271	5,117	6,276

	Fiscal Year					Thirteen Weeks Ended	
Deferred tax provision	18,353	13,360	9,758	12,973	(1,788)	1,909	830
Cumulative effect of accounting change, net				9,262			
Valuation allowance reversal	(30,843)						
Non-cash rent expense and other	4,779	3,985	6,014	4,283	9,181	2,323	1,594