UVA-F-1691
Rev. Jan. 24, 2017

M&M Pizza

Twenty-nine-year-old Moe Miller had recently been appointed managing director at M&M Pizza, a premium pizza producer in the small country of Francostan. As a third-generation director of M&M Pizza, Miller was anxious to make his mark on the company with which he had grown up. The business was operating well, with full penetration of the Francostani market, but Miller felt that the financial policies of the company were overly conservative. Despite generating strong and steady profitability of about F$125 million per year over recent memory, M&M Pizza's stock price had been flat for years, at about F$25 per share.[1]

His new office, Miller discovered, had an unobstructed view of the nearby marble quarry. How wonderfully irrelevant, he thought to himself as he turned to the financial analysis on his desk. With borrowing costs running at only 4%, he felt confident that recapitalizing the balance sheet would create sustained value for M&M owners. His plan called for issuing F$500 million in new company debt and using the proceeds to repurchase F$500 million in company shares. The plan would leave assets, profits, and operations of the business unchanged but allow M&M to borrow at the relatively low prevailing market yields on debt and increase dividends per share. Committed to raising the share price, Miller felt it was time to slice up the company's capital structure a little differently.

Francostan

The Mediterranean island nation of Francostan had a long tradition of political and economic stability. The country had been under the benevolent rule of a single family for generations. The national economy maintained few ties with neighboring countries, and trade was almost nonexistent. The population was stable, with approximately 12 million prosperous, well-educated inhabitants. The country was known for its exceptional IT and regulation infrastructure; citizens had unrivaled access to business and economic information. Economic policies in the country supported stability. Price inflation for the national currency, the Franco dollar, had been near zero for some time and was expected to remain so for the foreseeable future. Short- and long-term interest rates for government and business debt were steady at 4%. Occasionally, the economy experienced short periods of economic expansion and contraction.

The country's population was known for its high ethical standards. Business promises and financial obligations were considered fully binding. To support the country's practices, the government maintained no bankruptcy law, and all contractual obligations were fully and completely enforced. To encourage economic

[1] F$ = Franco dollars.

development, the government did not tax business income. Instead, government tax revenue was levied through personal income taxes. There was a law under consideration to alter the tax policy by introducing a 20% corporate income tax. To maintain business investment incentives under the plan, interest payments would be tax deductible.

The Recapitalization Decision

Miller's proposed recapitalization involved raising F$500 million in cash by issuing new debt at the prevailing 4% borrowing rate and using the cash to repurchase company shares.[2] Miller was confident that shareholders would be better off. Not only would they receive F$500 million in cash, but Miller expected that the share price would rise. M&M maintained a dividend policy of returning all company profits to equity holders in the form of dividends. Although total dividends would decline under the new plan, Miller anticipated that the reduction in the number of shares would allow for a net increase in the dividends paid per remaining share outstanding. With a desire to set the tone of his leadership at M&M, Miller wanted to implement the initiative immediately. The accounting office had provided a set of pro forma M&M financial statements for the coming year (**Exhibit 1**).

Based on a rudimentary knowledge of corporate finance, Miller estimated the current cost of equity (and WACC) for M&M with the current no-debt policy at 8% based on a market risk premium of 5% and a company beta of 0.8. Miller appreciated that, because equity holders bore the business risk, they deserved to receive a higher return. Nonetheless, from a simple comparison of the 8% cost of equity with the 4% cost of debt, equity appeared to be an expensive source of funds. To Miller, substituting debt for equity was a superior financial policy because it gave the company cheaper capital.[3] With other business inputs, the company was aggressive in sourcing quality materials and labor at the lowest available cost. Shouldn't M&M do the same for its capital?

[2] The recapitalization would change the number of shares outstanding for M&M from 62.5 million to 42.5 million.

[3] Miller's uncle, Mert, was highly skeptical of Miller's proposal. Uncle Mert claimed that substituting debt for equity capital shifted more business risk of the firm to equity holders, so they required higher returns. He countered that M&M's beta of 0.8 must increase in the following manner: Levered beta = (Unlevered beta) × [1 + (1 − t) × D / E], where t is the corporate tax rate, D is the debt value, and E is the equity value. With the F$500 million share-repurchase proposal, Uncle Mert asserted that M&M's D/E ratio would become 0.471.

Exhibit 1

M&M Pizza

Pro Forma Financial Statement
(in millions of Franco dollars, except per-share figures)

Income Statement	
Revenue	1,500
Operating expenses	1,375
Operating profit	125
Net income	125
Dividends	125
Shares outstanding	62.5
Dividends per share	2.00

Balance Sheet	
Current assets	450
Fixed assets	550
Total assets	1,000
Book debt	0
Book equity	1,000
Total capital	1,000

Source: Created by case writer.