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2007
Blaine Kitchenware, Inc.
Capital Structure

Corporate Evaluation for

Acquisition Opportunity

FIN458 Fall 2017

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Case Study #5

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12/17/2017

Brief Case 4040 / Blaine Kitchenware, Inc.: Capital Structure
by Harvard Business School

EXECUTIVE SUMMARY

Introduction

This study is to find the optimal capital structure of Blaine Kitchenware, Inc. (BKI) for 2007 in consideration of acquisition and/or stock repurchasing decisions. The company is family-owned even though it has been public, whose board members are descendants of founders and the financial policies and performances are quite traditional and thus BKI has been a debt-free company to date (except 2 times in 80 years). However, while it keeps the conventional policy such as holding prices in the competitive pressures only to expect 3% of topline operation growth, BKI could also consider repurchasing a large share in conjunction with existing policies concerning its liquidity, capital structure, dividend policy, ownership structure, and acquisition plans for better opportunity to increase CAGR. In this study, I would like to seek the optimal capital structure assuming BKI repurchases 14 million of its 59,630,000 outstanding shares and the impact on the financial conditions reflected on the financial statements.

The Problem Statement

On April 27, 2007 (in the middle of 2Q), Victor Dubinski, CEO of BKI was considering "unlocking" the under-levered equity by repurchasing its own outstanding shares for the first time in BKI history per his banker friend's advice. His advice points out that BKI to borrow money and buy back its own shares – to increase debt as a tax shield and possibly also EPS and ROE which is in the lowest range in the kitchenware industry, and thus is the reason the company is called over-liquid and under-levered.

Analysis of the Environment

One of the challenges due to the environment is that BKI has been run by the founders'

descendants for 80 years and has conservative long-standing policies, so Dubinski needs to pursue these receptive board members with reasonable assumption even though the debt requires interest payment and the buyback price is higher than current price. This plan also reduces its cash which the company has been using to acquire other companies for business expansion, but at this point in 2Q, BKI has no plans for acquisition for the year so this should not become an issue unless someone else has another attractive acquisition opportunity to bring to the table.

Industry itself has been introduced to the products with smart technology around 2007, and BKI's strategy is to secure Asian imports and private label products. Currently BKI brand products are well-known and well-regarded by consumers retailed at medium price points so this cannot be intruded for just a temporary solution.

Alternative Strategies

The alternative strategy may be left for other acquisition opportunities. However, at this point in the middle of the 2Q without a target, I'm not sure if the acquisition can be done within the 2007 budget. Considering all the processes required for acquisition, it does not seem to very realistic without affecting BKI's brand image, as in most cases, the current consumers and investors would not have the best impression with their companies' abrupt M&As without deliberate consent.

DETAILED CASE ANALYSIS

Quantitative Analysis

In my study, I found that BKI can lower its WACC by repurchasing its own stocks, which makes it a great opportunity to restructure corporate capital for operational assessment. BKI by far has no debt (except 2 times under socially conditional occasions, which were WWII and the first Oil Shock), and it makes its financial statements strongest amongst the peer group with EBITDA margin of 21.6% in 2006. In general, companies tend to seek WACC for investors through lower sources of financing, and it's time for BKI to review and leverage for potential capital gains and my assumption follows below.

The current cost of capital is all equity financed and it equals to CAPM by itself (weight of equity = 100%).

$$\mathbf{WACC = W_E \bullet K_E + W_D \bullet K_D(1\text{-}T)}$$

$$\mathbf{CAPM = r_f + \beta \bullet} \boldsymbol{risk\ premium}$$

Current beta is .56, levered or unlevered as BKI has no debt. The risk-free rate (r_f), and risk premium (spread) I use here are found in the Exhibit 4 as below;

Fig. 1

Seasoned corporate bond yields			Default spread	Yields on US Treasury Securities	
Moody's Aaa	5.88%		0.86%	Maturity	
Aa	6.04%		1.02%	10 years	**5.02%**
A	6.35%		**1.33%**		

So the current BKI's cost of capital is;

$WACC_{BKI} = CAPM_{BKI} = 5.02 + .56* 1.33 = 5.76\%$

I used rank A corporate bond yields for BKI in this calculation as the company is debt free and the financial policy is well maintained by family board members. However, according to BKI's

current financial statement, having $231M in cash and securities reduced enterprise value (MVIC) by its amount (MVIC = $729M) showing that they are not using their asset efficiently. And as a result, the payout ratio became significantly high at 52.9% as the net income growth is relatively lower at 2%, (Δ in NI in 2006 = $1.2M) while the number of outstanding shares increased by $5.5M at 24% due to the recent acquisitions. Current ROE is significantly low at 11% compared to the peer companies while the industry mean is 25.9% and the median is 19.5%. This should be also fixed by restructuring equity value.

The corporate operation without making debt is remarkably successful, but again, this can mean the company is not fully utilizing its possible opportunities which they can. Creating debt changes its tax amount as its interest is tax exempt, and the change in net income also affects EPS which is currently at $.90. The EPS was decreased in two years by $.39 at -30% due to issuing more outstanding shares consequently from the dilutive acquisitions.

Considering above, I would like to find an optimal capital structure which makes the best debt-to-equity ratio for BKI, so it minimizes the cost of capital. It should be at least lower than the current 5.76% as the current debt-to-equity ratio is 0:1 and it is possible if the after tax cost of debt (K_D*(1-T)) is lower than 5.76% with a positive net debt amount.

My recommendation to do so is by repurchasing BKI's own outstanding shares at higher price than its current price of $16.25 by creating debt to change the overall capital structure. Specifically, I simulate the repurchasing of its own 14M shares at $18.50 here, and would like to see how this works.

The first challenge is to pursue the idea to the receptive board members. Repurchasing 14M shares at $18.50 will cost $259M while BKI has only $231M in cash and securities (the most

liquid asset of BKI). In here we decide to use only $209M, leaving approx. $22M in hand to confirm security for old school board members. Thus this will have BKI to create $50M of debt for the starter. What happens to the ownership of the stocks from retiring those 14M shares is that this increases their ownership from current 62% to 81%.

Current # of Shares Owned = 59,630,000 * 62% = 36,971,000 shares

# of Shares Outstanding after Repurchase = 59,630,000 – 14,000,000 = 45,630,000

# of Shares Owned by BKI = 36,971,000/45,630,000 = 81%

Bigger shares of ownership make the owners more of a decision maker than having less. The owners of BKI will have more control as decision makers after repurchasing.

As a quick consequence of reducing the number of shares, EPS increases. EPS as said above, is currently $.90 = Net Income/# of Outstanding Shares = $53,630,000/59,630,000 . After repurchasing, the # of shares will be 45,630,000 and the EPS will be;

$53,630,000/45,630,000 = $1.16 . This is a 29% increase caused by the prospective repurchasing.

BKI's financial statement also shows the MVIC which is calculated by subtracting the amount of cash and securities from market capitalization, now $728,730,000. If you repurchase the stocks today while the price is $16.25, the market capitalization will be 45,630,000 shares * $16.25 = $741,487,500. The MVIC after repurchasing will be;

$741,487,500 - 21,866,000 = $719,621,500 and this is a little decrease.

$719,621,500/728,730,000 = 98.8% , so repurchasing causes MVIC change of -1.2% which can be said outside significance level.

What we need to discuss most importantly is the BKI's comparatively low ROE currently at 11% calculated in Net Income/Book Equity. To calculate the book equity, I use price-to-book ratio here which is;

Share Price / Book Value per Share = $16.25/ ($488,363,000/59,630) = 1.98

After repurchase, the market capitalization is $741,487,500 per above and divide by 1.98 for book value, which equals to $374,488,640. The BKI's net income is pretty stable the last 3 years so I use the average of it, which is $53,059,000. So the after-repurchasing ROE becomes; $53,059,000/$374,488,640 = 14.17% and now we have bettered the ROE.

These were the effect by the equity change. Now, I'd like to see the effect of the debt to be created, which is here with $50M. With this, the debt ratio will be $50,000,000/ 719,621,500 = 6.95% (W_D), which makes the weight of equity (W_E) = 100 – 6.95 = 93.65% .

One of the biggest benefits of having a debt material is that the interest paid for the debt created can be used as a tax shield. The interest rate we use here is again 6.35% for rank A companies, so the interest amount is $50M * 6.35% = $3,175,000 if they pay it off in one year to fully utilize the amount to be exempt. The difference between having $50M debt and without is found as below, considering the tax rate is 40% as given, EBIT is the average of the last 3 years = $62,337,000, and earnings before tax without debt is the average of last 3 years = $77,430,000.

Fig. 2

	Repurchase	No Repurchase
EBIT	62,337	62,337
Interest Paid from Debt	3,175	
Earnings before Tax	59,162	77,430
Tax at 40%	23,665	30,972
Save on Tax	**$7,308**	

($ in thousands)

As the interest amount to pay is $3,175,000, BKI can benefit the $7,308,000 – 3,175,000 =

$4,132,500 by creating $50M debt as it shows. From the figure above, you can also see the new net income is $35,947,000.

Finally I would like to see how the cost of capital is changed with the numbers affected by the repurchasing opportunity. The beta was .56 without debt, but now the beta needs to be relevered the debt ratio.

$$\beta_{Repurchase} = .56 \bullet \frac{93.05+6.95(1-.40)}{93.05} = .59$$

$CAPM_{Repurchase} = 5.02 + .59* 1.33 = 5.80\% = K_E$

$K_D = 6.35\%$

So the $WACC_{Repurchase} = 93.65\% * 5.80\% + 6.95\% * 6.35\% (1-.4) = 5.66\%$

and this is my optimal capital structure by creating debt of $50M. The repurchasing opportunity should be recognized for financial purposes.

The benefit of the capital restructure is as below;

Fig. 3

	Before Repurchase	After Repurchase
MVIC	$728,730	719,621.50
ROE	11%	14.45%
# of Shares Outstanding	59,630	45,630
EPS	0.90	1.16
Debt Ratio	0	6.95%
Current Ownership	62%	81%
(shares owned)	36,971	36,971
WACC	**5.76%**	**5.66%**

($ in thousands)

Support of Recommendation

Dubinski has been a CEO for a family owned company established 80 years ago and it's not hard to imagine that it takes a lot of effort to make a difference by introducing new systems. However, in his career the last 15 years as CEO, he has implemented BKI with notable exceptions such as

completing IPO in 2 years, and moving its production line abroad, so if he has strong materials that motivate business expansion and financial assessment, I believe he would do it. This capital restructuring scenario may seem a little obscure at first for a company that has not utilized the debt as a financial strategy but educating board members to adopt new type of business for future expansion is a part of his job as well. He should definitely deploy this plan to save his company.

References

Case: https://www.hbs.edu/faculty/Pages/item.aspx?num=41869

Appendix

Blaine_4055-XLS-ENG.xlsx