Kellogg School of Management

KEL082
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FIRM VALUE = excess cash + EV
Net debt + equity
• FCFF < lease ? >
• cost of capital ← effect of leverage on CoC

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Bed Bath & Beyond: The Capital Structure Decision

"Bed Bath & Beyond's earnings report could have been called Bed Bath & Brag," according to the New Jersey newspaper *The Record* in April 2004.[1] However, Bed Bath & Beyond (BBBY) had the performance to back up its boastfulness. Since going public in 1992, the home goods retailer, based in Union, New Jersey, had never missed an earnings estimate. For fiscal year 2003 (ending February 29, 2004) BBBY announced net income of $399 million on net sales of $4.5 billion, representing 22 percent growth in revenue and 32 percent growth in income over the previous fiscal year (see **Exhibit 1** through **Exhibit 4** for financial information).

In 2004 BBBY was amidst a large-scale expansion after adding 85 new stores in the preceding fiscal year. This growth had been financed internally with cash from operations. As analysts noted in summer 2003, the growing cash position of the company was causing return on equity to deteriorate. For a management constantly seeking ways to improve shareholder return, adding debt to the balance sheet was one possibility. In early 2004 interest rates were at an all-time low, making it an attractive time to consider issuing debt and executing either a share repurchase or a one-time special dividend.

become worst

Company History and Overview

BBBY was founded in 1971 by Warren Eisenberg and Leonard Feinstein. Initially, Eisenberg and Feinstein opened two stores, one in New York and one in New Jersey, under the name *bed n bath*. These small specialty stores carried primarily bed linens and bath accessories. In 1985 the company opened its first superstore, carrying a full line of domestics merchandise (bed linens, bath items, and kitchen textiles) and home furnishings (kitchen and tabletop items, small appliances, and basic housewares). In 1987 the company switched its name to Bed Bath & Beyond to reflect its broad merchandise offering. In March 2003 the co-founders turned over the CEO title to Steven Temares but retained their status as full-time co-chairmen.[2]

BBBY had been one of the early pioneers of the "big box" retail concept, which entailed dedicating a large, stand-alone store to a category that had previously been part of the offerings of large, general merchandise stores. While large department stores typically devoted about 20,000 square feet to home furnishings, BBBY stores averaged over 33,000 square feet and sometimes exceeded 80,000 square feet. This large size enabled BBBY to stock more than 30,000 SKUs (stock keeping units) in a typical store. By carrying a broad variety of household items, from bedding to bath items to kitchenware, BBBY offered one-stop shopping convenience for customers. In addition to its

[1] Joan Verdon, "Bed Bath & Beyond's Earnings Climb, Top Analysts' Projections," *The Record,* April 6, 2004.

[2] Eisenberg and Feinstein remained actively involved in the day-to-day management of the business and retained significant ownership (more than 4 million shares each).

broader merchandise selection, BBBY maintained an everyday lower price policy that put its prices at or below department store sale prices.

Historically, sales for BBBY were less seasonal than for many other retailers, and brand name items comprised the majority of sales. BBBY used several of its stores to test new merchandise and constantly updated its merchandising mix. Recent additions included fine china and window treatments.

In look and feel, BBBY stores differed from competing stores. Groups of related products were displayed together in different parts of the store, creating the impression that the superstore was comprised of several separate specialty stores. In each store, a "racetrack" walkway ran throughout, encouraging customers to shop many different categories. Rather than investing in expensive store furnishings, BBBY put the focus on its merchandise, which was displayed from floor to ceiling. As most of the inventory was on display in the store, approximately 85 to 90 percent of store space was devoted to selling area (with the remainder used for warehousing, receiving, and office space).

# of stores

In addition to its Bed Bath & Beyond stores, BBBY also owned Harmon Stores, a discount health and beauty aid retailer, and Christmas Tree Shops (CTS), a retailer of home décor, giftware, and seasonal merchandise. At the end of fiscal year 2003 BBBY operated 575 Bed Bath & Beyond stores, 30 Harmon stores, and 24 CTS stores. Generally, stores were located in the suburban areas of medium- and large-sized cities. BBBY leased all of its stores over terms ranging from five to twenty years in duration (see **Exhibit 5**).

Impressive Results in a Fragmented Industry

BBBY was widely admired by equity analysts, despite management's tendency to conclude quarterly earnings calls within 15 minutes without allowing for questions. Considered one of the best-performing retail companies, and even one of the top-performing public companies, by 2003 BBBY had experienced a fortyfold increase in stock price since its 1992 initial public offering. This success could be attributed to several factors:

Good Customer Experience Leading to High Store Productivity. In addition to the broad merchandise selection at competitive prices, customers could expect top-notch service. Employees were always nearby and willing to provide customer assistance—even store managers regularly spent time on the store floor assisting customers. As a result, BBBY stores were more productive than competitors, as measured by sales per square foot.

Decentralized Store Control. Because corporate management believed it existed to serve the stores, store managers were given a high level of autonomy ความอิสระ in selecting merchandise and managing its presentation. Local store personnel monitored inventory and reordered as much as 75 percent of the merchandise. In addition to reducing stockouts and excess inventory, this strategy empowered local managers to carry the merchandise that met local needs.

High Margins. Despite its everyday low pricing strategy, BBBY's operating margin of 14.3 percent far exceeded the 5.1 percent margin of direct competitor Linens 'n Things (see **Exhibit 6** for financial information on competitors). Store managers, who understood the local climate, were able to identify good areas for markups and drive volume on those items. BBBY also carried private-label merchandise, which provided customers with high-quality items at a reasonable price and supplied healthy margins to BBBY. Finally, BBBY did not run sales and used markdowns primarily to clear excess inventory of discontinued items.

lease instead of owning stores?

Low Cost Structure. The BBBY culture focused on "wringing every possible nickel out of overhead."[3] For example, on the cover of its 2002 annual report, BBBY urged shareholders to elect to receive future annual reports and proxies via the Internet to save on mailing expenses. Corporate headquarters were housed in a nondescript yellow-brick building in Union, New Jersey. Many stores saved money on real estate by being located in free-standing buildings rather than more expensive regional malls. BBBY procurement policies were set up to maximize savings: initial purchases were made through the corporate buying office, and reordering was done by store managers. This system facilitated buyer/vendor negotiations on price for aggregate volume along with fewer stockouts and less excess inventory as local managers best understood demand patterns in their stores. BBBY also saved on distribution by shipping merchandise directly from vendors to stores and avoiding the use of central distribution centers. In addition, BBBY spent less on advertising than many other retailers, relying on word of mouth and low-cost mail circulars to drive traffic to its stores.

As of April 2004 BBBY was the largest superstore domestics retailer, although its market share was estimated at just 4 percent. Department stores and mass merchandisers (such as Target and Wal-Mart) accounted for the bulk of category sales. JC Penney, a mall-based department store chain, had the largest share in the market but had been losing share as it encountered financial difficulties. Kohl's, a discount department store located primarily in malls, also had considerable presence in the category. Target was acclaimed for its success in selling private-label home goods. Wal-Mart and Target, the leading general merchandise stores, had departments devoted to domestics and home furnishings but also carried a wide variety of other items, from apparel to electronics to health and beauty care items. Similarly, JC Penney and Kohl's offered apparel, shoes, and accessories in addition to their housewares departments. BBBY's success had attracted some direct superstore competitors, most notably Linens 'n Things, which was second in sales. In addition, BBBY competed with specialty stores such as Williams Sonoma and its subsidiaries Pottery Barn, Hold Everything, West Elm, and Chambers.

Financing Continued Expansion

~17 times

Since going public, BBBY had grown from 34 Bed Bath & Beyond stores to 575 by the end of fiscal year 2003. In addition, BBBY acquired Harmon in March 2002 for $25 million and CTS in June 2003 for $200 million in all-cash transactions.

In its 2003 10-K, company management confirmed its commitment to ongoing expansion. BBBY was expected to add 80 to 90 new stores in fiscal year 2004, eventually building to 1,050 stores within the United States. International expansion was also reportedly under consideration. As of February 28, 2004, management had already leased sites for 57 new stores and projected that opening these stores would entail $79.9 million in merchandise inventories; $43.1 million for furniture, fixtures, and leasehold improvements; and $11.8 million for store opening expenses.

future expansion

* excess cash is not a part of EV

BBBY stated its intention to use internally generated funds to finance its expansion. Cash, cash equivalents, and short-term investment securities on hand at the end of fiscal year 2003 had grown more than 40 percent in the preceding year to $867 million. It was estimated that BBBY's cash balance was $400 million higher than its ongoing requirements for growth and operations. Analysts expressed some concern about deteriorating return on equity, as the interest earned on investments had been subject to declining interest rates. BBBY did not pay dividends.

[3] Don Hogsett, "Big Box Bucks Retail Trend With Sky-High Performance," *Home Textiles Today,* December 22, 2003.

cost of equity ?

Significantly, BBBY had no long-term debt on its balance sheet. Upon acquiring CTS, BBBY immediately paid down its debt ($21.2 million, including prepayment penalties). The company maintained lines of credit for $125 million but had no outstanding borrowing under these lines. Industry journalist Don Hogsett commented on BBBY's debt-free balance sheet: "In another boost to profits, the retailer doesn't borrow money; it banks it, generating interest income as opposed to the interest expense that choked so many other companies."[4]

Although many analysts considered BBBY's balance sheet a strength that permitted greater flexibility, some commented on the risks of its growing cash balance. A sell-side equity analyst commented, "They ended the year with $867 million in cash and short-term securities even after a $200 million all-cash acquisition. By 2007, we project their cash balance to grow to over $3 billion." A buy-side analyst expanded on this view: "I think BBBY is an excellent concept and company. . . . Clearly, they are doing something right with regard to managing their business, since their results have been fantastic for as long as I can remember and the stores are awesome. However, a big issue among investors is their capital structure. No investor wants to see all that cash sitting on BBBY's books. They use it for store growth and small acquisitions, but they really do have too much excess cash. We have been begging the company to initiate a share repurchase program, but they are very old-fashioned and set in their ways: cash is king and debt is bad." BBBY's management might have been worried about the reaction of the ratings agencies to increasing its leverage. **Exhibits 7A** and **7B** show median values of key financial ratios for bonds in various Standard and Poor's bond rating categories.

concern about cash

These concerns raised questions about BBBY's historical capital structure: was it the most effective one for the future? By paying out excess cash and issuing debt, BBBY could improve return to equity holders and raise earnings per share. **Exhibit 8** shows pro forma figures at a 40 percent debt-to-total capital structure. This pro forma assumes that the company would use $400 million in excess cash and $636.3 million in borrowed funds to repurchase its shares. BBBY could also consider adding significantly more debt, such as recapitalizing to 80 percent debt-to-total capital. In the 80 percent debt-to-total capital scenario, it would borrow $1.27 billion and use those funds, in addition to the excess cash, to execute a share repurchase. Another suggested possibility was to pay out the funds to shareholders via a one-time special dividend. Although share repurchases were more commonly used, management was cognizant (aware) of the recent changes in taxation policy that were thought to have eliminated the tax disadvantages of dividends.

As of early April 2004 BBBY was in a position to issue a mix of short-term and long-term maturity bonds that would have a blended interest rate of 4.5 percent. (**Exhibit 9** shows the prevailing market interest rates.) Given the low interest rates in early 2004, the climate seemed favorable for BBBY to consider adding debt to its capital structure. The Federal Reserve Funds rate was at a 46-year low of 1 percent, although speculation was mounting that the Fed would soon raise its rate and trigger an increase in interest rates. BBBY's window of opportunity for issuing debt at low rates seemed to be growing shorter.

เร่งลูกค้าให้รีบออก bond

[4] Don Hogsett, "BBBY Profits Jump 37%," *Home Textiles Today,* April 5, 2004.

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Exhibit 1: Selected Financial Data for Bed Bath & Beyond ($ in thousands, except per share and selected operating data)

Fiscal Year Ended:[a]	29-Feb 2004	1-Mar 2003	2-Mar 2002	3-Mar 2001	26-Feb 2000	27-Feb 1999	28-Feb 1998	1-Mar 1997	25-Feb 1996	26-Feb 1995	27-Feb 1994	28-Feb 1993
Statement of earnings data												
Net sales ($)	4,477,981	3,665,164	2,927,962	2,396,655	1,857,505	1,382,345	1,057,135	816,912	597,352	437,807	304,571	216,411
Growth rate	22.2%	25.2%	22.2%	29.0%	34.4%	30.8%	29.4%	36.8%	36.4%	43.7%	40.7%	N/A
Gross profit	1,876,664	1,518,547	1,207,566	986,459	766,801	576,125	441,016	341,168	250,036	183,819	127,972	90,528
Gross margins	41.9%	41.4%	41.2%	41.2%	41.3%	41.7%	41.7%	41.8%	41.9%	42.0%	42.0%	41.8%
Operating profit	639,343	480,057	346,100	272,838	209,340	158,052	118,914	90,607	67,585	51,685	36,906	26,660
Operating margins	14.3%	13.1%	11.8%	11.4%	11.3%	11.4%	11.2%	11.1%	11.3%	11.8%	12.1%	12.3%
Net earnings	399,470	302,179	219,599	171,922	131,229	97,346	73,142	55,015	39,459	30,013	21,887	15,960
Growth rate	32.2%	37.6%	27.7%	31.0%	34.8%	33.1%	32.9%	39.4%	31.5%	37.1%	37.1%	N/A
Net margins	8.9%	8.2%	7.5%	7.2%	7.1%	7.0%	6.9%	6.7%	6.6%	6.9%	7.2%	7.4%
Diluted EPS ($)[b]	1.31	1.00	0.74	0.59	0.46	0.34	0.26	0.20	0.14	0.11	0.08	0.06
Selected operating data												
Stores open—end of period	575	490	396	311	241	186	141	108	80	61	45	38
Total square footage—end of period	19,353,000	17,255,000	14,724,000	12,204,000	9,815,000	7,688,000	5,767,000	4,347,000	3,214,000	2,339,000	1,512,000	1,128,000
% increase in comparable same-store sales	6.3%	7.9%	7.1%	5.0%	9.2%	7.6%	6.4%	6.1%	3.8%	12.0%	10.6%	7.2%
Selected balance sheet data												
Working capital ($)	1,199,752	914,220	715,439	532,524	360,585	267,557	188,293	127,333	91,331	74,390	56,001	34,842
Total assets	2,865,023	2,188,842	1,647,517	1,195,725	865,800	633,148	458,330	329,925	235,810	176,678	121,468	76,654
Return on assets[c]	15.8%	15.8%	15.4%	16.7%	17.5%	17.8%	18.6%	19.4%	19.1%	20.1%	22.1%	N/A
Long-term debt	—	—	—	—	—	—	—	—	5,000	16,800	13,300	—
Shareholders' equity	1,990,820	1,451,921	1,094,350	817,018	559,045	411,087	295,397	214,361	151,446	108,939	77,305	54,643
Return on equity[b]	20.1%	23.7%	23.0%	25.0%	27.1%	27.6%	28.7%	30.1%	30.3%	32.2%	33.2%	N/A

Source: Company's 2002 Annual Report and Fiscal Year Ending Earnings Release.

Note: The company has never declared a cash dividend.

[a] Year ending 2/29/04 is Fiscal Year 2003.

[b] Net EPS amounts for fiscal 2000 and prior have been adjusted for two-for-one stock splits, distributed in fiscal 2000, 1998, 1996, and 1993.

[c] Based on average total assets. Does not include after-tax interest expense for 1994–1996.

Sales per sq.ft ?

more productive than competitors pg.2

Exhibit 2: Balance Sheet for Bed Bath & Beyond, FYE 2001–2003 ($ in thousands)

	29-Feb-2004	1-Mar-2003	2-Mar-2002
Current assets:			
Cash and cash equivalents	825,015	515,670	429,496
Short-term investment securities	41,580	100,927	—
Merchandise inventories	1,012,334	915,671	753,972
Other current assets	90,357	62,123	43,249
Total current assets	1,969,286	1,594,391	1,226,717
Noncurrent assets:			
Long-term investment securities	210,788	148,005	51,909
Property and equipment, net	516,164	423,907	361,741
Goodwill and other assets	168,785	22,539	7,150
Total assets	2,865,023	2,188,842	1,647,517
Current liabilities:			
Accounts payable	398,650	362,965	270,917
Accrued expenses and other current liabilities	337,039	246,198	190,923
Income taxes payable	33,845	71,008	49,438
Total current liabilities	769,534	680,171	511,278
Noncurrent liabilities			
Deferred rent and other liabilities	104,669	56,750	41,889
Total liabilities	874,203	736,921	553,167
Shareholders' equity:			
Common stock—$0.01 par value; authorized—900,000 shares; issued and outstanding—February 28, 2004, 300,278 shares and March 1, 2003, 294,430 shares	3,003	2,944	2,914
Additional paid-in capital	433,404	294,034	238,672
Retained earnings	1,554,413	1,154,943	852,764
Total shareholders' equity	1,990,820	1,451,921	1,094,350
Total liabilities and shareholders' equity	2,865,023	2,188,842	1,647,517

Exhibit 3: Income Statement for Bed Bath & Beyond, FYE 2001–2003 ($ in thousands)

	29-Feb-2004	1-Mar-2003	2-Mar-2002
Net sales	4,477,981	3,665,164	2,927,962
Cost of sales	2,601,317	2,146,617	1,720,396
Gross profit	1,876,664	1,518,547	1,207,566
Selling, general, and administrative expenses	1,237,321	1,038,490	861,466
Operating profit	639,343	480,057	346,100
Interest income	10,202	11,291	10,972
Earnings before provision for income taxes	649,545	491,348	357,072
Provision for income taxes	250,075	189,169	137,473
Net earnings	399,470	302,179	219,599
Net earnings per share—basic	1.35	1.03	0.76
Net earnings per share—diluted	1.31	1.00	0.74
Weighted average shares outstanding—basic	296,854	292,927	289,877
Weighted average shares outstanding—diluted	304,690	301,147	298,667

Exhibit 4: Statement of Cash Flows for Bed Bath & Beyond, FYE 2001–2003 ($ in thousands)

	29-Feb-2004	1-Mar-2003	2-Mar-2002
Cash flows from operating activities:			
Net earnings	399,470	302,179	219,599
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization	84,645	74,825	62,547
Amortization of bond premium	1,185	985	—
Tax benefit from exercise of stock options	64,832	31,176	31,980
Deferred income taxes	(3,061)	(13,291)	1,733
(Increase) decrease in assets, net of effects of acquisitions:			
Merchandise inventories	(27,058)	(145,789)	(147,268)
Other current assets	(2,055)	(7,927)	644
Other assets	5,466	190	206
Increase (decrease) in liabilities, net of effects of acquisitions:			
Accounts payable	19,341	86,144	78,516
Accrued expenses and other current liabilities	36,628	52,891	62,123
Income taxes payable	(37,993)	20,378	17,450
Deferred rent and other liabilities	7,042	17,556	10,426
Net cash provided by operating activities	$548,442	$419,317	$337,956
Cash flows from investing activities:			
Purchase of investment securities	(361,013)	(368,008)	(51,909)
Redemption of investment securities	357,020	170,000	—
Payments for acquisitions, net of cash acquired	(175,487)	(24,097)	—
Capital expenditures	(112,999)	(135,254)	(121,632)
Net cash used in investing activities	$(292,479)	$(357,359)	$(173,541)
Cash flows from financing activities:			
Proceeds from exercise of stock options	74,597	24,216	25,753
Prepayment of acquired debt	(21,215)	—	—
Net cash provided by financing activities	$53,382	$24,216	$25,753
Net increase in cash and cash equivalents	309,345	86,174	190,168
Cash and cash equivalents:			
Beginning of period	515,670	429,496	239,328
End of period	825,015	515,670	429,496

Exhibit 5: Excerpt from Bed Bath & Beyond's 2003 Annual Report Regarding Operating Leases

The company leases retail stores, as well as warehouses, office facilities, and equipment, under agreements expiring at various dates through 2029. Certain leases provide for contingent rents (which are based upon store sales exceeding stipulated amounts and are immaterial in fiscal 2003, 2002, and 2001), scheduled rent increases, and renewal options generally ranging from five to twenty years. The Company is obligated under a majority of the leases to pay for taxes, insurance, and common area maintenance charges.

As of February 28, 2004, future minimum lease payments under noncancelable operating leases are as follows:

Fiscal Year	Amount (in thousands)
2004	273,934
2005	285,298
2006	283,051
2007	274,325
2008	265,991
Thereafter	1,344,563
Total future minimum lease payments	2,727,162

Expenses for all operating leases were $251.0 million, $219.8 million, and $178.7 million for fiscal 2003, 2002, and 2001, respectively.

COGS or SG&A?

Exhibit 6: Comparables Data for Bed Bath & Beyond ($ in thousands except per share and ratio data)[a]

	Bed Bath & Beyond	Williams Sonoma	Linens 'n Things	Target	Kohl's	JC Penney	Best Buy
Sales ($)	4,477,981	2,754,368	2,395,272	48,163,000	10,282,094	17,786,000	24,547,000
5-yr CAGR	26.5%	18.9%	17.6%	9.5%	22.8%	–9.8%	19.5%
EBIT ($)	639,343	254,787	121,953	3,519,000	1,023,304	790,000	1,304,000
EBIT margins	14.3%	9.3%	5.1%	7.3%	10.0%	4.4%	5.3%
Net income ($)	399,470	157,211	74,825	1,841,000	591,152	(928,000)	800,000
5-yr CAGR	32.2%	23.4%	14.5%	14.5%	25.2%	N/A	29.9%
Net margins	8.9%	5.7%	3.1%	3.8%	5.7%	–5.2%	3.3%
Return on common equity	20.1%	19.5%	9.8%	16.6%	14.1%	–17.1%	23.4%
Annual dividends ($)	N/A	N/A	N/A	0.28	N/A	0.50	0.40
5-yr CAGR	N/A	N/A	N/A	7.0%	N/A	–27.4%	N/A
Cash and equivalents	866,595	163,910	136,129	716,000	147,033	2,994,000	2,600,000
Accounts receivable	—	31,573	55,786	5,776,000	1,150,157	233,000	343,000
Inventory	1,012,334	404,100	701,928	5,343,000	1,606,990	3,156,000	2,607,000
PP&E, net	516,164	765,030	377,244	16,969,000	3,324,243	3,515,000	2,244,000
Total assets	2,865,023	1,470,735	1,335,273	31,392,000	6,698,450	18,300,000	8,652,000
Total debt[b]	—	37,377	—	11,083,000	1,088,502	5,374,000	850,000
Total liabilities	874,203	666,144	573,554	20,327,000	2,507,111	12,875,000	5,230,000
Shareholders' equity	1,990,820	804,591	761,719	11,065,000	4,191,339	5,425,000	3,422,000
Market capitalization	12,171,014	3,899,885	1,593,834	40,420,163	16,089,477	9,517,079	16,982,748
Interest expense[c]	—	(851)	1,045	559,000	75,240	261,000	N/A
EBIT interest coverage[d]	N/A	N/A	116.7	6.3	13.6	3.0	N/A
Total debt to capital[e]	N/A	4.4%	0.0%	50.0%	20.6%	49.8%	19.9%
Bond rating[f]	N/A	N/A	N/A	A+	A–	BB+	BBB–
Bond rating last updated	N/A	N/A	N/A	8/21/01	12/4/00	5/29/03	6/21/01

[a] 2003 fiscal year ending 2/29/2004 for Bed Bath & Beyond, 2/1/2004 for Williams Sonoma, 1/3/2004 for Linens 'n Things, 1/31/2004 for Target, 1/31/2004 for Kohl's and JCPenney, 2/28/2004 for Best Buy.
[b] Includes ST debt, current maturities, LT debt, and capital leases.
[c] From 2003 annual reports.
[d] Calculated using Standard and Poor's EBIT Interest Coverage formulas in Exhibit 8.
[e] Calculated as total debt as percentage of total debt and shareholder's equity.
[f] Bond ratings based on Standard and Poor's rating system. Moody's had equivalent ratings for each company.

Exhibit 7A: Standard and Poor's Three-Year Median Key Industrial Financial Ratios, 2000–2002

	AAA	AA	A	BBB	BB	B	CCC
EBIT interest coverage (x)	23.4	13.3	6.3	3.9	2.2	1.0	0.1
EBITDA interest coverage (x)	25.3	16.9	8.5	5.4	3.2	1.7	0.7
FFO/total debt (%)	214.2	65.7	42.2	30.6	19.7	10.4	3.2
Free operating cash flow/total debt (%)	156.6	33.6	22.3	12.8	7.3	1.5	(2.8)
Return on capital (%)	35.0	26.6	18.1	13.1	11.5	8.0	1.2
Operating income/sales (%)	23.4	24.0	18.1	15.5	15.4	14.7	8.8
Long-term debt/capital (%)	(1.1)	21.1	33.8	40.3	53.6	72.6	78.3
Total debt/capital (%)	5.0	35.9	42.6	47.0	57.7	75.1	91.7
Number of companies	6	20	121	224	279	264	56
Average default rate, past 15 years[a]	0.52%	1.31%	2.32%	6.64%	19.52%	35.76%	54.38%

Source: Standard & Poor's

[a] Based on the bond's original ratings.

Exhibit 7B: Formulas for Key Ratios

$$\text{EBIT interest coverage} = \frac{\text{Earnings from continuing operations}^{a}\text{ before interest and taxes}}{\text{Gross interest incurred before subtracting capitalized interest and interest income}}$$

$$\text{EBITDA interest coverage} = \frac{\text{Earnings from continuing operations before interest, taxes, and D\&A}}{\text{Gross interest incurred before subtracting capitalized interest and interest income}}$$

$$\text{Funds from operations/total debt} = \frac{\text{Net income from continuing operations plus D\&A, deferred income taxes, and other noncash items}}{\text{LT debt}^{b}\text{+ current maturities, commercial paper, and other short-term borrowings}}$$

$$\text{Free operating cash flow/total debt} = \frac{\text{FFO – CapEx –(+) increase(decrease) in working capital (excluding changes in cash, marketable securities, and ST debt)}}{\text{LT debt}^{b}\text{ + current maturities, commercial paper, and other short-term borrowings}}$$

$$\text{Return on capital} = \frac{\text{EBIT}}{\text{Avg. beginning and ending year capital}^{c}}$$

$$\text{Operating income/sales} = \frac{\text{Sales – cost of goods sold (before D\&A), SG\&A costs, and R\&D costs}}{\text{Sales}}$$

$$\text{Long-term debt/capital} = \frac{\text{LT debt}^{b}}{\text{LT debt}^{b}\text{ + shareholder's equity (including preferred stock) + minority interest}}$$

$$\text{Total debt/EBITDA} = \frac{\text{LT debt}^{b}\text{ + current maturities, commercial paper, and other short-term borrowings}}{\text{Earnings from continuing operations before interest, taxes, and D\&A}}$$

$$\text{Discretionary cash flow/total debt} = \frac{\text{FFO – CapEx –(+) increase(decrease) in working capital (excluding changes in cash, marketable securities, ST debt) – common/preferred dividends}}{\text{LT debt}^{b}\text{ + current maturities, commercial paper, and other short-term borrowings}}$$

Source: Standard & Poor's Corporate Rating Criterion. Revised August 21, 2003.

[a] Including interest income and equity earnings; excluding nonrecurring items, interest expense, depreciation, and amortization.

[b] Includes amounts for operating lease debt equivalent, and debt associated with accounts receivable sales securitization programs.

[c] Includes ST debt, current maturities, LT debt,[b] noncurrent deferred taxes, minority interest, and equity (common and preferred stock).

Exhibit 8: Pro Forma 2003 Results for Alternative Capital Structures ($ in thousands)

	Actual 2003	Pro Forma 2003 40% Debt To Total Capital[d]
Sales	4,477,981	$ 4,477,981
Operating profit	639,343	639,343
Interest income[a]	10,202	5,493
EBIT	649,545	644,836
Interest expense[b]	—	28,635
Profit before taxes	649,545	616,201
Taxes[c]	250,075	237,237
Profit after tax	399,470	378,964
EPS—basic	1.35	1.41
EPS—diluted	1.31	1.37
Average shares outstanding—basic	296,854	268,845
Average shares outstanding—diluted	304,690	276,681
Cash and equivalents[e]	866,595	466,595
Total debt		636,328
Total repurchase amount[f]		1,036,328
Shareholders' equity	1,990,820	954,492
Common stock price (4/30/04)	37.00	—
Market value of common stock	10,983,598	—
Shares repurchased		28,009

[a] Pro forma interest income adjusted for reduction in cash balances.

[b] Based on BBBY's blended interest expense rate on debt assumed to be 4.5%.

[c] Tax rate assumed to be 38.5%, based on actual 2003 results.

[d] Assumes firm continues with policy of not paying dividends.

[e] Cash and equivalents reduced by $400 million in excess cash.

[f] Includes excess cash and debt.

Exhibit 9: Market Interest Rates—April 2004

Government Debt Interest Rates	
One-year Treasury bill	1.19%
Five-year Treasury note	2.79%
Ten-year Treasury bond	3.83%
Corporate Bond Rates	
AAA	5.33%
AA	5.48%
A	5.75%
BBB	6.10%

Source: DRI Basic Economics