BRIEF CASES

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W. CARL KESTER
SUNRU YONG

Winfield Refuse Management, Inc.: Raising Debt vs. Equity

It was early June 2012, and Mamie Sheene was checking her team's calculations yet again. The next board of directors meeting was in just two days, and she needed to be sure her presentation was perfect. As chief financial officer of Winfield Refuse Management, a vertically integrated, nonhazardous waste management company, it was Sheene's responsibility to lead the discussion on how to finance a major acquisition. This question had led to contentious debate at the last board meeting, and she needed to make sure that the board could reach a resolution this time.

Industry Background

In the United States, waste comprised two main categories: hazardous and nonhazardous. The former was produced primarily by manufacturing, and its disposal was strictly regulated. Examples of hazardous waste included infectious medical waste, asbestos, heavy metals, corrosive waste acid or alkali liquid, and ignitable waste oil. The nonhazardous waste category included various types of industrial waste, as well as municipal solid waste—what most people commonly referred to as trash or garbage.

Private operators typically collected, processed, and disposed of nonhazardous commercial and industrial waste. Municipal solid waste could be managed by the municipalities themselves, but nearly 80% of this was also outsourced to the private sector. A waste management operator collected the waste and then processed it for recovery (i.e., recycling), combustion for energy recovery, or disposal. The typical operation was very asset-intensive and usually required local collection vehicles, long-distance vehicles, transfer stations, material recovery facilities, disposal facilities, and landfills.

The industry was highly fragmented, with a few national, publicly traded players such as Waste Management Inc. and Republic Services competing with numerous regional operators. With a few exceptions, most local and regional waste companies were privately held. Larger companies benefited from economies of scale by controlling a larger inflow of waste, thereby increasing throughput and using their processing facilities and landfills more efficiently. The waste

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management market was growing slower than overall GDP, with the waste from an increasing population offset by declining waste per-capita, thanks to increased recycling and composting. However, the business usually generated very steady cash flows. Demand was predictable and recession-proof, and most operators worked on multiyear contracts with their industrial and residential customers (see **Exhibit 1** for financial data of select publicly traded waste management companies).

History of Winfield Refuse

In 1972, Thomas Winfield founded Winfield Refuse as a two-truck operation in Creve Coeur, Missouri. In the four decades since, the company grew through a combination of organic growth and strategic acquisitions. In 2012, it served nearly a half-million industrial, commercial, and residential customers in nine states, primarily in the Midwest. Winfield's assets included 22 landfills and 26 transfer stations and material recovery facilities, which served 33 collections operations. Although the Winfield family kept several seats on the board, outside professional management had been brought in during the 1980s. The current CEO, Leo Staumpe, had previously managed the Michigan operation and served as COO before being promoted to CEO in 1997.

Since its founding, Winfield's board had adhered to a consistent policy of avoiding long-term debt. The steady cash flow generated by the business, short-term bank loans, and the proceeds of the 1991 public stock offering had been sufficient to meet its financing needs. As of 2012, the capital structure consisted of common stock, with no interest-bearing debt. The Winfield family and senior management held 79% of the common stock. The remaining shares were widely distributed and traded infrequently in the over-the-counter market.

Expansion Opportunity

In its early years, Winfield relied primarily on organic growth to expand its operation. Starting in the early 1990s, the company made a series of small, "tuck-in" acquisitions. It targeted companies that would extend its geographic reach while creating economies of scale with its existing facilities. The management team had proven successful in the post-acquisition phase, avoiding undue disruption while efficiently integrating new companies into its operations. In 2010, Winfield began actively seeking a larger acquisition target to solidify its competitive position in the Midwest. The team had observed that major competitors, both publicly traded and private equity-backed, had become more aggressive in executing a "roll-up," or consolidation strategy, of smaller waste management companies. Facing these larger, more efficient players, it was important for Winfield Refuse to maintain a competitive cost position on a regional basis.

In mid-2011, after a study of several potential acquisition targets, Winfield began discussions with Mott-Pliese Integrated Solutions (MPIS), a waste management company serving parts of Ohio, Indiana, Tennessee, and Pennsylvania. The MPIS assets were not an obvious strategic fit with any other likely acquirer, but its footprint would both improve Winfield's cost position in the Midwest and provide an initial entry into the mid-Atlantic region. Furthermore, the business was well-run, with a strong management team that had consistently produced 12%–13% operating margins every year for the past 10 years. The company was privately held, had virtually no long-term debt, and the owners were looking for an exit. After some negotiations, Winfield and the MPIS management reached an initial understanding, settling on an acquisition price of $125 million. The Winfield management team believed this was a fair price. MPIS also indicated that it would accept up to 25% of the purchase price in Winfield stock.

Board Discussion

Leo Staumpe believed that MPIS was an excellent fit and offered tremendous revenue synergies and cost reduction opportunities. The MPIS acquisition was large enough for Winfield that external financing would be required. An investment bank had indicated that, barring a major market decline, new common stock could be issued at $17.75 per share. Net of underwriting fees and expenses, net proceeds to Winfield would be $16.67 per share. An issuance of 7.5 million shares would be required for MPIS.

Winfield's performance had been steady and the company reliably paid dividends. However, for the past few years, the performance of Winfield stock had been disappointing (see **Exhibit 2** for profit, dividends, and stock price data). As a result, Staumpe and Sheene wanted to reconsider the policy of avoiding long-term debt. They believed the anticipated stability of the combined Winfield-MPIS business would support such a decision. Sheene determined that the company could sell $125 million in bonds to a Massachusetts insurance company. The annual interest rate would be 6.5% and they would mature in 15 years. Annual principal repayments of $6.25 million would be required, leaving $37.5 million outstanding at maturity. Although the bonds' repayment terms would create a sizable on-going need for cash, Sheene believed that they were the best available to Winfield.

Because the interest payments on the bond would be tax deductible, Sheene felt that issuing debt was the most economically attractive option. At Winfield's current marginal tax rate of 35%, the 6.5% rate would be the equivalent of 4.225% on an after-tax basis, due to the tax shield allowed on interest payments. By comparison, Sheene calculated a 6% annual cash cost for a stock issuance netting $16.67 per share if Winfield maintained a dividend payment of $1.00 per share.

At the board meeting in March 2012, the board agreed with Staumpe's recommendation on MPIS and unanimously approved the merger. However, there was decidedly less agreement on the matter of financing. Sheene presented her cash cost calculations and her rationale for issuing a bond, and she was taken aback as a contentious debate broke out among the board. Andrea Winfield immediately challenged Sheene's numbers, pointing out that annual principal repayments had been excluded and that Winfield already had long-term liabilities (see **Exhibit 3** for Winfield's balance sheet):

> The stock issue clearly has a lower cost. The principal repayments on the bond mean we have an additional $6.25 million cash outlay every year. That is over 9% of the bond issue. With all our long-term leases, Winfield already has significant financial commitments. Assuming this debt burden will increase risk and will lead to wild swings in the stock price.

Andrea's uncle, Joseph Winfield, weighed in on the same side of the argument:

> The math is very simple. With earnings before interest and taxes [EBIT] of $24 million, MPIS will generate over $15 million each year after taxes. With an additional 7.5 million shares sold to finance this and dividends remaining at $1.00 per share, that comes to just $7.5 million annually. In terms of the new shares, MPIS clearly pays for itself—how can we say that we are hurting existing shareholders? It's obvious that the bond issue is a bad idea!

A third director, Ted Kale, took the opposite position and became rather agitated about what he believed were Winfield's grossly undervalued shares:

> It would be a travesty for us to issue at a price of $17.75. Each of our major competitors has a higher price-equity ratio than we do, and issuing new shares at this time would be a disservice to shareholders. We also need to worry about diluting management's control of

> Winfield by issuing equity. Taking this approach is a huge gift to new shareholders at the expense of current ones!

Two other directors, Joseph Tendi and Naomi Ghonche, concurred with Kale about not issuing new common stock, but argued that this needed to be measured in terms of earnings per share (EPS), rather than book or replacement value. After making some quick calculations, Tendi explained:

> We have to be careful not to dilute the stock's value. The EBIT of the combined Winfield-MPIS entity would be $66 million. Issuing common stock would dilute EPS to $1.91. Using debt, on the other hand, could bump the EPS up to $2.51. That makes this the right choice for shareholders. The principal repayment obligation comes to $0.42 per share, but I think this is irrelevant to the discussion.

Finally, James Gitanga, the newest addition to the board, weighed in with observations about financing in the waste management industry:

> All the other major players rely on long-term debt in their capital structures. Winfield's balance sheet is unusual in this industry, and I do not know if our policy against debt is justified.

With no conclusion among the directors, Staumpe suggested finalizing the financing decision in the June board meeting. This would allow Sheene and her team to prepare additional materials to facilitate the discussion.

Now with the June meeting in just two days, Sheene once again thought through the many issues and arguments raised in the prior meeting. She needed a way to focus the discussion. To help with that, she designed a chart that compared the debt and equity alternatives (see **Exhibit 4** for an assessment of the financing alternatives).

Exhibit 1 Financial data of select waste industry companies (Q2 2012 data, except where noted)

	Market Cap. *($ billions)*	Price-Earnings Ratio	Return on Avg Equity	Long-Term Debt to Equity	Operating Margin, 2011
Waste Management	$ 15.9	17.4	13.5%	1.5	13.5%
Republic Services	10.2	15.3	7.8%	0.9	16.4%
Waste Connections	3.7	22.4	9.4%	0.6	21.1%
Progressive Waste Solutions	2.3	NA	9.0%	1.1	-4.8%
Casella Waste Systems	0.13	NA	-139.5%	26.2	-4.7%

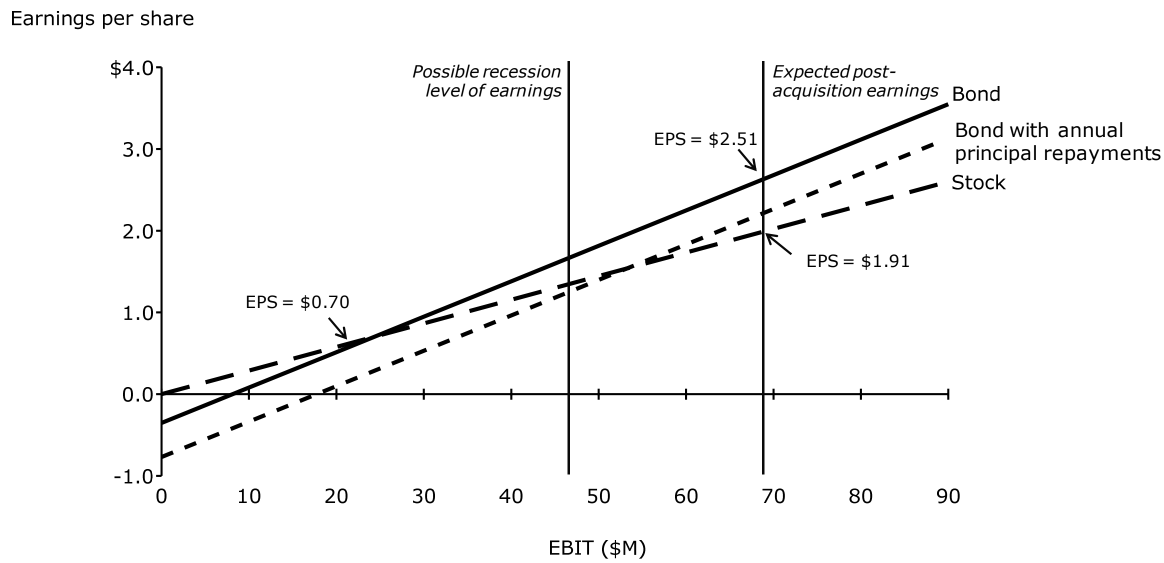
Exhibit 2 Winfield Inc, income, dividends, and stock price data (thousands of dollars except per-share data)

						Market Prices Per Share	
	Operating Revenue	Income Before Taxes	Income After Taxes	Earnings Per Share	Dividends Per Share	High	Low
2006	325,088	32,509	21,456	1.43	0.85	17.03	15.50
2007	349,556	35,655	23,889	1.59	0.90	17.71	16.51
2008	371,868	33,097	21,546	1.44	0.90	14.70	11.91
2009	379,457	35,290	22,903	1.53	1.00	16.56	14.65
2010	383,223	38,002	24,853	1.66	1.00	18.80	16.90
2011	395,440	40,539	26,350	1.76	1.00	21.20	17.55
2012E	410,223	42,121	27,379	1.83	1.00		

Exhibit 3 Winfield Inc., summary balance sheet (thousands of dollars)

	2011
Cash	$ 27,330
Accounts receivable	48,741
Prepaid expenses	7,488
Current assets	**83,559**
Net operating property	522,043
Goodwill	101,423
Other assets	42,656
Total assets	**$ 749,681**
Accounts payable	36,998
Miscellaneous payables and accruals	25,883
Current portion, capital lease	1,420
Current liabilities	**$ 64,301**
Capital leases	15,813
Common stock	15
Paid-in surplus	146,257
Retained earnings	523,295
Long-term liabilities and equity	**685,380**
Total liabilities and stockholders equity	**$ 749,681**

Exhibit 4 Post-acquisition EBIT chart



Calculation of points to determine lines (thousands of dollars except outstanding shares and per-share data

	EBIT = $24.35M		EBIT = $66.0M	
	Bonds	**Stock**	**Bonds**	**Stock**
EBIT	24,350	24,350	66,000	66,000
Interest, 1st year	8,125	-	8,125	-
Earnings before tax	16,225	24,350	57,875	66,000
Tax @ 35%	5,679	8,523	20,256	23,100
After-tax earnings	10,546	15,828	37,619	42,900
Shares outstanding (millions)	15.0	22.5	15.0	22.5
Earnings per share	$ 0.70	$ 0.70	$ 2.51	$ 1.91
Annual principal repayments	6,250	–	6,250	–

Note: The effect of leverage and dilution are indicated by the differing slopes of the lines and can be expressed: "For each million dollar change in EBIT, the bond plan brings a change in EPS that is $0.014 higher than the stock plan. Leverage is favorable from EBIT of $24.35 million upward."