



BRIEF CASES

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Blaine Kitchenware, Inc.: Capital Structure

On April 27, 2007, Victor Dubinski, CEO of Blaine Kitchenware, Inc. (BKI), sat in his office reflecting on a meeting he had had with an investment banker earlier in the week. The banker, whom Dubinski had known for years, asked for the meeting after a group of private equity investors made discreet inquiries about a possible acquisition of Blaine. Although Blaine was a public company, a majority of its shares were controlled by family members descended from the firm's founders together with various family trusts. Family interests were strongly represented on the board of directors as well. Dubinski knew the family had no current interest in selling—on the contrary, Blaine was interested in acquiring other companies in the kitchen appliances space—so this overture, like a few others before it, would be politely rebuffed.

Nevertheless, Dubinski was struck by the banker's assertion that a private equity buyer could “unlock” value inherent in Blaine's strong operations and balance sheet. Using cash on Blaine's balance sheet and new borrowings, a private equity firm could purchase all of Blaine's outstanding shares at a price higher than \$16.25 per share, its current stock price. It would then repay the debt over time using the company's future earnings. When the banker pointed out that BKI itself could do the same thing—borrow money to buy back its own shares—Dubinski had asked, “But why would we do that?” The banker's response was blunt: “Because you're over-liquid and under-levered. Your shareholders are paying a price for that.” In the days since the meeting, Dubinski's thoughts kept returning to a share repurchase. How many shares could be bought? At what price? Would it sap Blaine's financial strength? Or prevent it from making future acquisitions?

Blaine Kitchenware's Business

Blaine Kitchenware was a mid-sized producer of branded small appliances primarily used in residential kitchens. Originally founded as The Blaine Electrical Apparatus Company in 1927, it produced then-novel electric home appliances, such as irons, vacuum cleaners, waffle irons, and cream separators, which were touted as modern, clean, and easier to use than counterparts fueled by oil, coal, gas, or by hand. By 2006, the company's products consisted of a wide range of small kitchen appliances used for food and beverage preparation and for cooking, including several branded lines of deep fryers, griddles, waffle irons, toasters, small ovens, blenders, mixers, pressure cookers, steamers, slow cookers, shredders and slicers, and coffee makers.

HBS Professor Timothy A. Luehrman and Illinois Institute of Technology Adjunct Finance Professor Joel L. Heilprin prepared this case solely as a basis for class discussion and not as an endorsement, a source of primary data, or an illustration of effective or ineffective management. This case, though based on real events, is fictionalized, and any resemblance to actual persons or entities is coincidental. There are occasional references to actual companies in the narration.

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Blaine had just under 10% of the \$2.3 billion U.S. market for small kitchen appliances. For the period 2003–2006 the industry posted modest annual unit sales growth of 2% despite positive market conditions including a strong housing market, growth in affluent householders, and product innovations. Competition from inexpensive imports and aggressive pricing by mass merchandisers limited industry dollar volume growth to just 3.5% annually over that same period. Historically, the industry had been fragmented, but it had recently experienced some consolidation that many participants expected to continue.

In recent years, Blaine had been expanding into foreign markets. Nevertheless in 2006, 65% of its revenue was generated from shipments to U.S. wholesalers and retailers, with the balance coming from sales to Canada, Europe, and Central and South America. The company shipped approximately 14 million units a year.

There were three major segments in the small kitchen appliance industry: food preparation appliances, cooking appliances, and beverage-making appliances. Blaine produced product for all three, but the majority of its revenues came from cooking appliances and food preparation appliances. Its market share of beverage-making appliances was only 2%. Most of BKI's appliances retailed at medium price points, at or just below products offered by the best-known national brands. BKI's market research consistently showed that the Blaine brand was well-known and well-regarded by consumers. It was associated somewhat with "nostalgia" and the creation of "familiar, wholesome dishes."

Recently, Blaine had introduced some goods with "smart" technology features and sleeker styling, targeting higher-end consumers and intended to compete at higher price points. This strategy was in response to increased competition from Asian imports and private label product. The majority of BKI's products were distributed via a network of wholesalers, which supplied mass merchandisers and department stores, but its upper-tier products were sold directly to specialty retailers and catalogue companies. Regardless of the distribution channel, BKI offered consumers standard warranty terms of 90 days to one year, depending on the appliance.

Blaine's monthly sales reached a seasonal peak during October and November as retailers increased stock in anticipation of the holiday season. A smaller peak occurred in May and June, coinciding with Mother's Day, a summer surge in weddings, and the seasonal peak in home purchases. Historically, sales of Blaine appliances had been cyclical as well, tending to track overall macroeconomic activity. This also was the case for the industry as a whole; in particular, changes in appliance sales were correlated with changes in housing sales and in home renovation and household formation.

BKI owned and operated a small factory in Minnesota that produced cast iron parts with specialty coatings for certain of its cookware offerings. Otherwise, however, Blaine, like most companies in the appliance industry, outsourced its production. In 2006 BKI had suppliers and contract manufacturers in China, Vietnam, Canada, and Mexico.

Victor Dubinski was a great-grandson of one of the founders. An engineer by training, Dubinski served in the U.S. Navy after graduating from college in 1970. After his discharge, he worked for a large aerospace and defense contractor until joining the family business in 1981 as head of operations. He was elected to the board of directors in 1988 and became Blaine's CEO in 1992, succeeding his uncle.

Under Dubinski's leadership, Blaine operated much as it always had, with three notable exceptions. First, the company completed an IPO in 1994. This provided a measure of liquidity for certain of the founders' descendants who, collectively, owned 62% of the outstanding shares

following the IPO. Second, beginning in the 1990s, Blaine gradually moved its production abroad. The company began by taking advantage of NAFTA, engaging suppliers and performing some manufacturing in Mexico. By 2003, BKI also had established relationships with several Asian manufacturers, and the large majority of its production took place outside the United States. Finally, BKI had undertaken a strategy focused on rounding out and complementing its product offerings by acquiring small independent manufacturers or the kitchen appliance product lines of large diversified manufacturers. The company carefully followed changes in customer purchasing behavior and market trends. Victor Dubinski and the board were eager to continue what they believed had been a fruitful strategy. The company was particularly keen to increase its presence in the beverage appliance segment, which demonstrated the strongest growth and where BKI was weakest. Thus far, all acquisitions had been for cash or BKI stock.

Financial Performance

During the year ended December 31, 2006, Blaine earned net income of \$53.6 million on revenue of \$342 million. **Exhibits 1 and 2** present the company's recent financial statements. Approximately 85% of Blaine's revenue and 80% of its operating income came from the sale of mid-tier products, with the line of higher-end goods accounting for the remainder. The company's 2006 EBITDA margin of nearly 22% was among the strongest within the peer group shown in **Exhibit 3**. Despite its recent shift toward higher-end product lines, Blaine's operating margins had decreased slightly over the last three years. Margins declined due to integration costs and inventory write-downs associated with recent acquisitions. Now that integration activities were completed, BKI executives expected the firm to achieve operating margins at least as high as its historical margins.

The U.S. industry as a whole faced considerable pressure from imports and private label products, as well as a shift in consumer purchasing preferences favoring larger, "big box" retailers. In response, some of Blaine's more aggressive rivals were cutting prices to maintain sales growth. Blaine had not followed suit and its organic revenue growth had suffered in recent years, as some of its core products lost market share. Growth in Blaine's top line was attributable almost exclusively to acquisitions.

Despite the company's profitability, returns to shareholders had been somewhat below average. Blaine's return on equity (ROE), shown below, was significantly below that of its publicly traded peers.¹ Moreover, its earnings per share had fallen significantly since 2004, partly due to dilutive acquisitions.

Companies	2006 ROE
Home & Hearth Design	11.3%
AutoTech Appliances	43.1%
XQL Corp.	19.5%
Bunkerhill Incorporated	41.7%
EasyLiving Systems	<u>13.9%</u>
Mean	25.9%
Median	19.5%
Blaine	11.0%

¹ ROE is computed here as net income divided by end-of-period book equity.

During 2004–2006, compounded annual returns for BKI shareholders, including dividends and stock price appreciation, were approximately 11% per year. This was higher than the S&P 500, which returned approximately 10% per year. However, it was well below the 16% annual compounded return earned by shareholders of Blaine's peer group during the same period.

Financial Policies

Blaine's financial posture was conservative and very much in keeping with BKI's long-standing practice and, indeed, with its management style generally. Only twice in its history had the company borrowed beyond seasonal working capital needs. The first time was during World War II, when it borrowed from the U.S. government to retool several factories for war production. The second time was during the first oil shock of the 1970s. On both occasions the debt was repaid as quickly as possible.

At the end of 2006, Blaine's balance sheet was the strongest in the industry. Not only was it debt-free, but the company also held \$231 million in cash and securities at the end of 2006, down from \$286 million two years earlier. Given such substantial liquidity, Blaine had terminated in 2002 a revolving credit agreement designed to provide standby credit for seasonal needs; the CFO argued that the fees were a waste of money and Dubinski agreed.

In recent years the company's largest uses of cash had been common dividends and cash consideration paid in various acquisitions. Dividends per share had risen only modestly during 2004–2006; however, as the company issued new shares in connection with some of its acquisitions, the number of shares outstanding climbed, and the payout ratio rose significantly, to more than 50% in 2006.

	2004	2005	2006
Net income	\$ 53,112	\$ 52,435	\$ 53,630
Dividends	\$ 18,589	\$ 22,871	\$ 28,345
Average shares outstanding	41,309	48,970	59,052
Earnings per share	\$ 1.29	\$ 1.07	\$ 0.91
Dividend per share	\$ 0.45	\$ 0.47	\$ 0.48
Payout ratio	35.0%	43.6%	52.9%

The next largest use of funds was capital expenditures, which were modest due to Blaine's extensive outsourcing of its manufacturing. Average capital expenditures during the past three years were just over \$10 million per year. While they were expected to remain modest, future expenditures would be driven in part by the extent and nature of Blaine's future acquisitions. In recent years, after-tax cash generated from operations had been more than four times average capital expenditures and rising, as shown in the table below.

	2004	2005	2006	AVG.
EBITDA	\$ 69,370	\$ 68,895	\$ 73,860	
Less: Taxes	24,989	24,303	23,821	
After-Tax Operating Cash Flow	44,380	44,592	50,039	46,337

Reassessing Financial Policies in 2007

In 2007 Blaine planned to continue its policy of holding prices firm in the face of competitive pressures. Consequently, its managers were expecting top line growth of only 3% for fiscal year 2007. However, this growth rate assumed no acquisitions would be made in 2007, unlike the previous two years. While the board remained receptive to opportunities, Dubinski and his team had no target in mind as yet at the end of April.

As he reflected on the possibility of repurchasing stock, Dubinski understood that he could consider such a move only in conjunction with all of BKI's financial policies: its liquidity, capital structure, dividend policy, ownership structure, and acquisition plans. In addition, he wondered about timing. Blaine's stock price was not far off its all-time high, yet its performance clearly lagged that of its peers. A summary of contemporaneous financial market information is provided in **Exhibit 4**.

Dubinski had begun to suspect that family members on the board would welcome some of the possible effects of a large share repurchase. Assuming that family members held on to their shares, their percentage ownership of Blaine would rise, reversing a downward trend dating from BKI's IPO. It also would give the board more flexibility in setting future dividends per share. Both Dubinski and the board knew that the recent trend in BKI's payout ratio was unsustainable and that this concerned some family members.

On the other hand, a large repurchase might be unpopular if it forced Blaine to give up its war chest and/or discontinue its acquisition activity. Perhaps even more unsettling, it would cause Blaine to borrow money. The company would be paying significant interest expense for only the third time in its history. As Dubinski turned his chair to face the window, he glanced at the framed photo behind his desk of his great grandfather, Marcus Blaine, demonstrating the company's first cream separator—its best-selling product during Blaine's first decade. A real Blaine Electrical Cream Separator sat in a glass case in the corner; the last one had been manufactured in 1949.

Exhibit 1 Blaine Kitchenware, Inc., Income Statements, years ended December 31, (\$ in Thousands)

<u>Operating Results</u>	2004	2005	2006
Revenue	\$291,940	\$307,964	\$342,251
Less: Cost of Goods Sold	<u>204,265</u>	<u>220,234</u>	<u>249,794</u>
Gross Profit	87,676	87,731	92,458
Less: Selling, General & Administrative	25,293	27,049	28,512
Operating Income	62,383	60,682	63,946
Plus: Depreciation & Amortization	6,987	8,213	9,914
EBITDA	69,370	68,895	73,860
EBIT	62,383	60,682	63,946
Plus: Other Income (expense)	15,719	16,057	13,506
Earnings Before Tax	78,101	76,738	77,451
Less: Taxes	24,989	24,303	23,821
Net Income	53,112	52,435	53,630
Dividends	\$ 18,589	\$ 22,871	\$ 28,345
Margins			
Revenue Growth	3.2%	5.5%	11.1%
Gross Margin	30.0%	28.5%	27.0%
EBIT Margin	21.4%	19.7%	18.7%
EBITDA Margin	23.8%	22.4%	21.6%
Effective Tax Rate ^a	32.0%	31.7%	30.8%
Net Income Margin	18.2%	17.0%	15.7%
Dividend payout ratio	35.0%	43.6%	52.9%

^a. Blaine's future tax rate was expected to rise to the statutory rate of 40%.

Exhibit 2 Blaine Kitchenware, Inc. Balance Sheets, December 31, (\$ in Thousands)

<u>Assets</u>	2004	2005	2006
Cash & Cash Equivalents	\$ 67,391	\$ 70,853	\$ 66,557
Marketable Securities	218,403	196,763	164,309
Accounts Receivable	40,709	43,235	48,780
Inventory	47,262	49,728	54,874
Other Current Assets	2,586	3,871	5,157
Total Current Assets	376,351	364,449	339,678
Property, Plant & Equipment	99,402	138,546	174,321
Goodwill	8,134	20,439	38,281
Other Assets	13,331	27,394	39,973
Total Assets	\$497,217	\$550,829	\$592,253
<u>Liabilities & Shareholders' Equity</u>			
Accounts Payable	\$ 26,106	\$ 28,589	\$ 31,936
Accrued Liabilities	22,605	24,921	27,761
Taxes Payable	14,225	17,196	16,884
Total Current Liabilities	62,935	70,705	76,581
Other liabilities	1,794	3,151	4,814
Deferred Taxes	15,111	18,434	22,495
Total Liabilities	79,840	92,290	103,890
Shareholders' Equity	<u>417,377</u>	<u>458,538</u>	<u>488,363</u>
Total Liabilities & Shareholders' Equity	\$497,217	\$550,829	\$592,253

Note: Many items in BKI's historical balance sheets (e.g., Property, Plant & Equipment) have been affected by the firm's acquisitions.

Exhibit 3 Selected Operating and Financial Data for Public Kitchenware Producers, 12 months ended December 31, 2006, (\$ in Thousands)

	Home & Hearth Design	AutoTech Appliances	XQL Corp.	Bunkerhill, Inc.	EasyLiving Systems	Blaine Kitchenware
Revenue	\$ 589,747	\$18,080,000	\$4,313,300	\$3,671,100	\$ 188,955	\$ 342,251
EBIT	106,763	2,505,200	721,297	566,099	19,613	63,946
EBITDA	119,190	3,055,200	796,497	610,399	23,356	73,860
Net income	\$ 53,698	\$1,416,012	\$ 412,307	\$ 335,073	\$ 13,173	\$ 53,630
Cash & securities	\$ 21,495	\$ 536,099	\$ 21,425	\$ 153,680	\$ 242,102	\$ 230,866
Net working capital ^a	54,316	1,247,520	353,691	334,804	21,220	32,231
Net fixed assets	900,803	7,463,564	3,322,837	815,304	68,788	174,321
Total assets	\$ 976,613	\$9,247,183	\$3,697,952	\$1,303,788	\$ 332,110	\$ 592,253
Net debt ^b	\$ 350,798	\$4,437,314	\$ 950,802	\$ 238,056	\$ (64,800)	\$ (230,866)
Total debt	372,293	4,973,413	972,227	391,736	177,302	-
Book equity	475,377	3,283,000	2,109,400	804,400	94,919	488,363
Market capitalization	776,427	13,978,375	5,290,145	3,962,780	418,749	959,596
Enterprise value (MVIC)	\$1,127,226	\$18,415,689	\$6,240,947	\$4,200,836	\$ 353,949	\$ 728,730
Equity beta	1.03	1.24	0.96	0.92	0.67	0.56
LTM Trading Multiples						
MVIC/Revenue	1.91x	1.02x	1.45x	1.14x	1.87x	2.13x
MVIC/EBIT	10.56x	7.35x	8.65x	7.42x	18.05x	11.40x
MVIC/EBITDA	9.46x	6.03x	7.84x	6.88x	15.15x	9.87x
Market/Book equity	1.63x	4.26x	2.51x	4.93x	4.41x	1.96x
Net Debt/Equity	45.18%	31.74%	17.97%	6.01%	-15.47%	-24.06%
Net Debt/Enterprise Value	31.12%	24.10%	15.23%	5.67%	-18.31%	-31.68%

^{a.} Net working capital excludes cash and securities.^{b.} Net debt is total long-term and short-term debt less excess cash.

Exhibit 4 Contemporaneous Capital Market Data (April 21, 2007)**Yields on U.S. Treasury Securities****Maturity**

30 days	4.55%
60 days	4.73%
90 days	4.91%
1 year	4.90%
5 years	4.91%
10 years	5.02%
20 years	5.26%
30 years	5.10%

Seasoned corporate bond yields**Default spread**

Moody's Aaa	5.88%	0.86%
Aa	6.04%	1.02%
A	6.35%	1.33%
Baa	6.72%	1.70%
Ba	7.88%	2.86%
B	8.94%	3.92%