# Case #2: Blaine Kitchenware

Group 5
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**The Transaction:.** Consider the following share repurchase proposal: Blaine will use $209 million of cash from its balance sheet and $50 million in new debt-bearing interest at the rate of 6.75% to repurchase 14 million shares at a price of $18.50 per share.

**1.**

From a shareholder perspective, Blaine's capital structure and payout policies are favorable in the short-term, but not ideal for long-term growth. It is structured in a way to maximize dividends to shareholders given high liquidity, with a significantly increasing payout ratio of 35% in 2004 to 52.9% in 2006, which is concerning when we consider this payout ratio in the context of Blaine's net debt and competitor standing. Taking a look at Blaine's net debt, $ (230,866.00) (Exhibit 1), they are clearly not leveraging debt to grow the business which is putting them at a big disadvantage relative to competitors, such as Home & Health Design or XQL Corp. who have net debt / equity ratios of 45.18% and 17.97%, respectively, as well as higher ROE.

**2.**

Ultimately, management should not recommend a large share repurchase to Blaine's board given factors contrary to tax shields, such as the probability of bankruptcy. In addition, the opportunity cost of the share repurchase is much higher, given more effective means of leveraging debt for Blaine including acquisition and raising capital as debt. In addition, some shareholders and investors may view the stock repurchase as a manipulation of Blaine's capital structure, which could adversely affect Blaine's reputation. On the other hand, the stock repurchase can leverage factors such as tax shields to increase the valuation of the business (in light of contrary factors such as the probability of bankruptcy). As a part of this, key financial ratios can be improved like EPS and ROE, signaling confidence in current and prospective shareholders. Finally, a stock repurchase provides more flexibility than other means of leveraging debt, as they do not commit the company to regular payouts; this can provide more financial flexibility in the future to aide in Blaine's growth.

**3.**

*** (Supporting calculations can be found in the Appendix (Exhibit 1))**

| Parameter | 2006 WITHOUT Transaction | 2006 WITH Transaction | Calculation | Assumptions |
|---|---|---|---|---|
| **EBIT** | $ 63,945.75 | $ 63,945.75 | No calculation made - unchanged since change in financial structure are strictly post-tax implications | EBIT remains unchanged whether capital structure changes or not |
| **Other Income (Expense)** | $ 13,505.66 | $ 13,505.66 | No calculation made - assumption is no fees or expenses incurred in the debt issuance/stock repurchase event | No fees charged to Blaine for capital restructure |
| **Earnings Before Tax** | $ 77,451.41 | $ 74,076.41 | Need to subtract interest expense from EBIT here. Interest expense is:<br><br>*2006 Interest Payment = 0.0675 * 50,000,000 = 3,375,000* | See above |
| **Corporate Taxes Paid** | $ 23,821.02 | $ 22,785.90 | *Taxes paid = [tax rate] * (earnings before tax)* | **Tax Rate = 30.76%**. No significant changes in other income or pre-tax expenses have occurred. Non-transaction is same as in Exhibit 1, with-transaction is a calculation. |
| **Net Income** | $ 53,630.39 | $ 51,290.51 | *Net Income = EBIT - interest - taxes paid* | |
| **Operating Free Cash Flow** | $ 57,441.80 | $ 55,101.91 | *FCF = Net Income + D&A - dNWC* | D&A and NWC are given in Exhibits 1 and 2. There is a NWC calc in Exhibit 3 but the items included (and excluded) aren't clear so we assumed NWC = Inventory + Accounts Receivable - Accounts Payable. |
| **Earnings per share** | $ 0.91 | $ 1.14 | *EPS = Net Income/(Shares Outstanding)* | # of shares outstanding reduced by 14 million |
| **ROE** | 10.98% | 22.36% | *ROE = Net Income / Book Value of Equity* | We're assuming that the $259M used to repurchase stock is a commensurate reduction in equity held by shareholders, and that the repurchased stock are considered assets in the form of "treasury stock" after the transaction (which is immaterial for ROE considerations). The reduction in cash and addition of debt are accompanied by an equivalent increase in a post-transaction "treasury stock" category and decrease in book equity. |
| **Net Debt** | $ (230,866.00) | $ 28,134.00 | *Net Debt = Debt - Cash - (Other non-operating assets)* | Net Debt increases by the $50M added in the transaction as well as the 209M cash paid for stock repurchases. Non-transaction Net Debt is provided in Exhibit 3. The resulting treasury stock is *not* considered a non-operating asset. It is considered a contra-equity account. |

**4.**

Assumptions:

- Risk-Free Rate (rF) = 5.10%
- Equity Beta (βE) = 0.56
- Corporate Tax Rate, 2006 (T) = 30.76%
- Total Equity, 2006 (E) = $488,363,000
- Net Debt, 2006 (D) = $-230,866,000
- rD = Risk-Free Rate (rF) = 5.10%
- Equity Risk Premium (E ( rM - rF ) = 6%

(a) βU = 0.38, rU = 7.36%
(b) βE = 0.56. rE = 8.46%
(c) rW ACC = 12.88%

Before the transaction, βU is lower than βE as it only considers the company's operational risks, not capital structure. βE is reflecting the additional risk taken by equity holders due to the company's financial leverage.

**5.**

Using the WACC from the pre-transaction unlevered value of the firm (18.9%), in combination with the calculated annual tax savings of $1,035 million, we value the present value of the income tax shields at approximately $8,037million (Figure 5.1). On a per share basis this represents a value of $0.18/share. If the company were to move forward with share repurchase at a price of $18.50, a $2.25 premium to the current trading price, the premium paid per-share is much greater compared to the value of the tax savings. We would expect to see an increase in per share value by $2.43/share (Figure 5.1) from the increased price of the stock for remaining shareholders and from the value of the tax shields.

**6.**

a. Bu = 69.61%, ru = 9.28%
b. Be = 68.2%, re = 8.56%
c. WACC = 8.41%

Generally, the proposed structure results in an increase in the non-diversifiable risk impact on the firm's equity, firm's operating free cash flows, but a decrease in company WACC. By increasing the firm's total debt and changing the capital structure of the firm, the unlevered beta and unlevered cost of capital increases, as well as the total equity beta and total equity cost of capital for the firm. This is the effect of the financial leverage on the firm, as debt now has the first claim to any of the company's future free cash flows due to the change in leverage and structure, making this additionally risky. This increases the inherent riskiness of Blaine's equity. Interestingly, the book value of equity is projected to fall post transaction as equity is reduced to finance the additional debt, making the equity in place riskier due to the increased risk of paying

debt holders in the future. However, the projected market value of equity is actually higher post transaction, driven by the premium paid to the shareholders and the benefit of the restructuring on equity due to net present value of the future savings from the tax shield (see exhibit 5.1). Despite an increase in the non-diversifiable risk in the market value of equity and the restructuring of the debt with the tax shield, WACC falls as a result in the impact on the tax shield savings, resulting in a more favorable WACC for Blaine from 12.88% to 8.41%

| | **Post** | **Pre** |
|---|---|---|
| Bu | **69.61%** | 37.67% |
| ru | **9.28%** | 7.36% |
| Be | **0.682** | 56.00% |
| re | **8.56%** | 8.46% |
| WACC | **8.41%** | 12.88% |

**7.**

Since the net benefit to shareholders is greater than zero at $2.43 (see exhibit 5.1) per share with this restructuring, both family members and non-family members alike would be supportive of this change. Further, the market value of equity increases in this transaction, driven largely by the positive net effect to equity driven by the premium paid on the stock price and the savings per share provided by the restructured debt's tax shield savings (net present value). The resulting higher market value of equity supports that this a net positive transaction for all shareholders.  If none of the family members sold their shares during the transaction, their family ownership percentage would change from **63% prior to transaction to 81% of shares** (see exhibit 7). This is because the total number of shares available falls, making the family's percentage ownership of total shares increase. Based on the projected market value for equity, this means of the nearly $940M in equity, the families ownership of that equity would increase to $716M, more than doubled from their $300M in equity pre-transaction.

# Appendix:

## Exhibit 1 (Supporting Calcs for Q3):

| Calculated Tax Rate | 2006 Numbers | | |
|---|---|---|---|
| Earnings before taxes | 77,451 | | |
| Taxes Paid | 23,821 | | |
| Tax rate | 30.76% | | |
| | | | |
| **Change in NWC** | **2005** | **2006** | |
| *+Inventory* | 49,728 | 54,874 | |
| *+Accounts Receivable* | 43,235 | 48,780 | |
| *+Other Current Assets* | 3,871 | 5,157 | |
| *-Accounts Payable* | 28,589 | 31,936 | |
| *-Other Accrued Liabilities* | 24,921 | 27,761 | |
| *-Taxes Payable* | 17,196 | 16,884 | **Change in Net Working Capital** |
| | 26,128 | 32,231 | 6,103 |
| | | | |
| **Change in Outstanding Shares** | **# of Shares** | | |
| *2006 WITHOUT Transaction* | 59,052 | **Assumption**: Market price is $18.50 / share | |
| *Stocks Repurchased* | 14,000 | | |
| *2006 WITH Transaction* | 45,052 | | |
| | | | |
| **Change in equity** | **Equity Book Value** | | |
| *2006 WITHOUT Transaction* | $488,363 | From Exhibit 3 | |
| *Equity Reduction* | 259,000 | **Assumption:** The $259M repurchase (and increase in debt) reduces total equity held by shareholders | |
| *2006 WITH Transaction* | $229,363 | | |

## Exhibit 5.1 - Value of Income Tax Shields

| Blaine Kitchenware | | | |
|---|---|---|---|
| Item | Value | Source | |
| **Present Value of Tax Savings** | | | |
| Annual Tax Savings | $1,035.12 | Calculated in Q3 | |
| Discount Rate | 12.88% | Calculated in Q4 | |
| **Present Value of Tax Savings** | **$8,037.25** | Calculated | |
| | | | |
| **Net Value of Repurchase to Shareholders** | | | |
| Number of Shares Outstanding | 45,052 | Question 3 Calculation | |
| Value Created per Share | $0.18 | Calculated | |
| Premium Paid to Current Shareprice | $2.25 | Provided in Question Stem & Case Page 1 | |
| **Net Benefit (Cost) of Repurchase** | $2.43 | Calculated | |

## Exhibit 6:

## Post Transaction Analysis

| **Variable** | **Value** | **Note** |
|---|---|---|
| Risk-Free Rate (rF) | 5.10% | unchanged from Q4 |
| Equity Beta (βE) | 0.682 | Bu*(D+E)/E = BE |
| Corporate Tax Rate, 2006 (T) | 30.76% | unchanged from Q4 |
| Total Equity, 2006 (E), Market Value Post Transaction | $942,867.98 | Number of shares * Share Price - exhibit 6.2 |
| Total Debt, 2006 (D) | $28,134.00 | net debt post transaction, from Q3 |
| Cost of Debt (rD) | 5% | Given by Q6 prompt |
| Equity Risk Premium (E ( rM - rF )) | 6% | Unchanged |
| Unlevered Beta (βU) | 69.61% | resulting changes in equity and debt result in higher unlevered beta post transaction |
| Unlevered Cost of Capital (rU) | 9.28% | resulting changes in equity and debt result in |

| | | |
|---|---|---|
| | | higher cost of capital post transaction |
| Cost of Equity (rE) | 8.56% | re=ra + D/E*(ra-rd) |
| Weighted Average Cost of Capital (rW ACC) | 8.41% | Lower WACC for company. |
| ra | 8.46% | transaction has no effect on assets, so Ra = pre transaction re |

## Exhibit 6.2

| **Market Value of Equity post Transaction** | Value |
|---|---|
| Number of Shares | 45,052 |
| Starting Market Share Price | $18.50 |
| Transaction Benefit to Shareholders | $0.18 |
| Premium Paid to Shareholders | $2.25 |
| Ending Effective Market Price | $20.93 |
| Projected Total Equity Post Transition, Market Value | **$942,867.98** |

## Exhibit 7

## Percentage of Shares Held By Family - Post Transaction

| | | |
|---|---|---|
| Percentage Held by Family (Pre) | 62% | |
| Number of Shares (Pre) | 59,052 | |
| Number of shares held by family | 36613 | |
| Number of Shares (post) | 45,052 | |
| New % held by family (post) | 81.27% | |
| | | |
| | **Value** | **Ownership Type** |
| Net Benefit to Shareholders | $2.43 | Shareholders - all |
| | | |
| | **Equity** | **% Equity held by Family** |
| Pre Equity | $488,363 | $302,784.98 |
| Post Equity | $942,867.98 | $766,251.48 |