Case #2: Blaine Kitchenware

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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, Dubinski 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: *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