Applied Corporate Finance

A New Financial Policy at Swedish Match

Class-Case Discussion

Rui Silva

Plan of Attack

- Background
- Discussion/Proposed Solution Of Case
- What Happened?

Background Of Case

- The case takes place in 2005
- Swedish Match, a company that produces smokeless tobacco, cigars, matches, and lighters, is considering a major change in capital structure
- The specific proposal we have to assess is:
  - Issue a SEK4 billion bond
  - Use the proceeds to buyback equity

Swedish Match

- Brought to prominence by Ivar Kreuger – "the match King"

- Krueger took over the family business and consolidated the match industry in Sweden
  - Went from 15 companies in 1903 to two main players in 1913
  - Consolidation was financed with debt and proceeds from Krueger's construction business
  - After WWI, J&V, which was the biggest competitor, was in difficulty and was acquired by Krueger
  - In 1916, Swedish Match was formed

Swedish Match (cont'd)

- From a Swedish monopoly to several national monopolies
  - Austria, Belgium, Finland, Hungary, Norway, the Netherlands, Switzerland

- This quick international growth exposed the limits of the Swedish capital markets

- Kreuger was able to finance the expansion by setting up International Match Company (IMCO)
  - Pioneer in the use of dual class share structure (what is this?)
  - Also pioneer in the use of convertible debt

Swedish Match (cont'd)

- How did governments allow monopolies in this industry?
  - Kreuger lended to governments in exchange for monopoly control of the match markets
- Why did investors go along?
  - They were ripping the benefits
  - Sustainable (monopoly) earnings
  - High dividend yield
- Is this optimal from a society point of view?
  - Probably not, even though it may be profit maximizing for the firm

Swedish Match (cont'd)

- In the aftermath of the Great Depression, lending dried up
- However, the business model was sustained on dividend payments
- To keep high dividend yield without access to debt financing, Kreuger engaged in fraud
- This was exposed when J.P. Morgan did an audit at a time when Kreuger tried to sell his stake in Ericsson
  - Swedish Match share price collapsed
  - Ivar Kreuger shot himself in a Paris hotel

Swedish Match (cont'd)

- But, the company survived.
- Divested several businesses and focused on matches in Sweden
- By 1992 the matching business was combined with the largest Swedish tobacco company
- Company was spun off and taken public in 1996
- Divested cigarette operations and focused on smokeless tobacco

Swedish Match in 2005

- At the time of the case the company consisted primarily of:
  - Smokeless tobacco
  - Premium cigars
  - Pipe tobacco

- At the moment, the company has a conservative financial policy
  - Market leverage of 11% [Ex. 1]
  - A- rating from S&P [Ex. 7]
  - Higher credit rating than competitors, lower leverage than competitors

New Financial Policy

- The company is now considering
  - Issue a new bond
  - Use the proceeds to buy back equity
  - Effectively increasing the leverage ratio

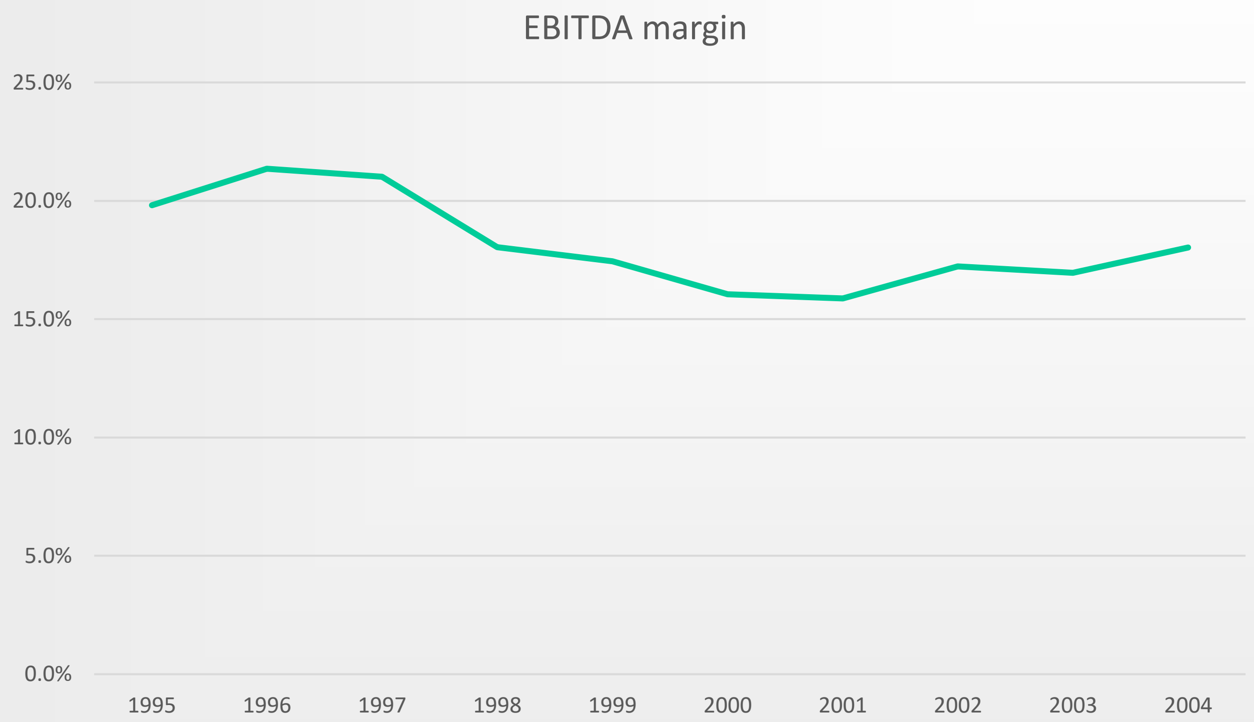
- What are the potential pros and cons of such a radical change in capital structure?

Pros of increasing leverage

- Tax shields
  - Higher leverage → lower taxable income → lower taxes
- Managerial incentives
  - Higher leverage is a way to address the free cash flow problem
  - What are other ways?
  - Discipline of debt repayments puts pressure on the firm to perform
- Monitoring by creditors
  - Especially if banks are involved and debt holdings are concentrated

Pros of increasing leverage (cont'd)

- Low business risk (addiction, non-cyclical)



- Has low leverage relative to comparables [Ex. 7]

Cons of leverage

- Risk of default or financial distress
  - Direct costs of financial distress
  - Indirect costs of financial distress
- Can it sustain dividend payment with higher leverage?
  - Do we care?
- Less financial flexibility
  - E.g., takeovers may become harder to finance if we exhaust our debt capacity
  - Growth opportunities may become harder to finance if we are already highly levered
- Will get a lower credit rating
  - Why do we care?
  - More on credit ratings later.

Value of interest tax shields

SM Income statement

[Ex. 2]

EBIT	1,865
- Interest	266
+ Other	1,829
= EBT	3,428
- Tax	1,345
= NI	2,083

Value of interest tax shields

SM Income statement

[Ex. 2]		Recap	
EBIT	1,865		1,865
- Interest	266	+180	446
+ Other	1,829		1,829
= EBT	3,428	- 180	3,248
- Tax	1,345	- 50	1,295
= NI	2,083	- 130	1,953

Value of interest tax shields

SM Income statement

[Ex. 2]		Recap	
EBIT	1,865		1,865
- Interest	266	+180	~~446~~
+ Other	1,829		1,829
= EBT	3,428	- 180	3,248
- Tax	1,345	- 50	1,295
= NI	2,083	- 130	1,953

4,000*0.045

Value of interest tax shields

SM Income statement

[Ex. 2]		Recap	
EBIT	1,865		1,865
- Interest	266	+180	446
+ Other	1,829		1,829
= EBT	3,428	- 180	3,248
- Tax	1,345	- 50	1,295
= NI	2,083	- 130	1,953
NI + Int	2,349	+ 50	2,399

Repeats every year "in perpetuity"

Value of interest tax shields

Annual tax saving = $r_D D\tau$

= (interest rate of 4.5%) × (debt of 4bn) × (tax rate of 28%)

= $SEK50m$

PV(annual tax saving) = ?

= $\frac{r_D D\tau}{1+r_D} + \frac{r_D D\tau}{(1+r_D)^2} + \frac{r_D D\tau}{(1+r_D)^3} + \cdots$ *"forever" (or "in perpetuity")*

= $\frac{r_D D\tau}{r_D} = D\tau = SEK4bn \times 28\% = SEK1.12bn$

Mechanics of a recap

Steps:	BVE	MVE	cash	debt
1. Announce recap		↑		
2. Sell bonds			↑	↑
3. Repurchase shares	↓	↓	↓	

How does this look on the book-value balance sheet?

How does it look on the market-value balance sheet?

Mechanics of a recap: BV

Now (2004)		
Assets	**Liabilities**	
14,898	3,529	Interest-bearing debt
	6,309	Current/other liabilities
	5,060	Equity

Mechanics of a recap: BV

Announcement		
Assets	**Liabilities**	
14,898 → _______	3,529 → _______	Interest-bearing debt
	6,309 → _______	Current/other liabilities
	5,060 → _______	Equity

Mechanics of a recap: BV

Announcement		
Assets	**Liabilities**	
14,898	3,529	Interest-bearing debt
	6,309	Current/other liabilities
	5,060	Equity

Mechanics of a recap: BV

Issue debt (4bn)		
Assets	**Liabilities**	
14,898 → _______	3,529→ _______	Interest-bearing debt
	6,309	Current/other liabilities
	5,060	Equity

Mechanics of a recap: BV

Issue debt (4bn)		
Assets	**Liabilities**	
18,898	*7,529*	Interest-bearing debt
	6,309	Current/other liabilities
	5,060	Equity

Mechanics of a recap: BV

Repurchase shares (4bn)		
Assets	**Liabilities**	
18,898 → _______	7,529	Interest-bearing debt
	6,309	Current/other liabilities
	5,060 → _______	Equity

Mechanics of a recap: BV

Repurchase shares (4bn)		
Assets	**Liabilities**	
14,898	7,529	Interest-bearing debt
	6,309	Current/other liabilities
	1,060	Equity

Mechanics of a recap: MV

Now (2004)		
Assets	**Liabilities**	
38,292	3,529	Interest-bearing debt
	6,309	Current/other liabilities
	28,454	Market value of equity
# shares outstanding	322.1 m (Ex. 2)	
Share price	88.34 (Ex. 2)	

Mechanics of a recap: MV

Announcement		
Assets	**Liabilities**	
38,292 → ______	3,529	Interest-bearing debt
	6,309	Current/other liabilities
	28,454 → ______	Market value of equity
# shares outstanding	322.1 m (Ex. 2)	
Share price	88.34 → ______	

Assume: market knows PV(tax shields), didn't anticipate the recap, and all benefits go to equity

Mechanics of a recap: MV

Announcement		
Assets	**Liabilities**	
39,412	3,529	Interest-bearing debt
	6,309	Current/other liabilities
	29,574	Market value of equity
# shares outstanding	322.1 m (Ex. 2)	
Share price	*91.82 (+4%)*	

Assume: market knows PV(tax shields), didn't anticipate the recap, and all benefits go to equity

Mechanics of a recap: MV

Issue debt (4bn)		
Assets	**Liabilities**	
39,412 → _______	3,529 → _______	Interest-bearing debt
	6,309	Current/other liabilities
	29,574	Market value of equity
# shares outstanding	322.1 m (Ex. 2)	
Share price	91.82	

Mechanics of a recap: MV

Issue debt (4bn)		
Assets	**Liabilities**	
43,412	*7,529*	Interest-bearing debt
	6,309	Current/other liabilities
	29,574	Market value of equity
# shares outstanding	322.1 m (Ex. 2)	
Share price	91.82	

Mechanics of a recap: MV

Repurchase shares (4bn)		
Assets	**Liabilities**	
43,412 → _______	7,529	Interest-bearing debt
	6,309	Current/other liabilities
	29,574 → _______	Market value of equity
# shares outstanding	322.1 m → _______	
Share price	91.82 → _______	

Mechanics of a recap: MV

Repurchase shares (4bn)		
Assets	**Liabilities**	
39,412	7,529	Interest-bearing debt
	6,309	Current/other liabilities
	25,574	Market value of equity
# shares outstanding	*278.5 m*	
Share price	*91.82*	

Ratings

- Before the recap, SM's market leverage ratio (=D/(D+MVE)) is ____________ and its coverage ratio (=EBITDA/interest) is ____________.
- SM should thus have a rating of around _________.

- If SM adds SEK4bn of debt at 4.5% interest, its market leverage ratio will increase to ___________ while its coverage ratio will drop to ___________.
- SM's new rating should thus be around __________.

Ratings

- Before the recap, SM's market leverage ratio (=D/(D+MVE)) is 3.5/(3.5+28.5) = 11% and its coverage ratio (=EBITDA/interest) is 2344/266 = 8.8.
- SM should thus have a rating of around ___.

- If SM adds SEK4bn of debt at 4.5% interest, its market leverage ratio will increase to ___________ while its coverage ratio will drop to ___________.
- SM's new rating should thus be around __________.

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- SM should thus have a rating of around **A**.

- If SM adds SEK4bn of debt at 4.5% interest, its market leverage ratio will increase to ____________ while its coverage ratio will drop to ____________.
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Ratings

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- SM should thus have a rating of around **A**.

- If SM adds SEK4bn of debt at 4.5% interest, its market leverage ratio will increase to (3.5+4)/(7.5+25.6) = 22.3% while its coverage ratio will drop to 2344/(266+180) = 5.3.
- SM's new rating should thus be around ___.

Ratings

- Before the recap, SM's market leverage ratio (=D/(D+MVE)) is 3.5/(3.5+28.5) = 11% and its coverage ratio (=EBITDA/interest) is 2344/266 = 8.8.
- SM should thus have a rating of around **A**.

- If SM adds SEK4bn of debt at 4.5% interest, its market leverage ratio will increase to (3.5+4)/(7.5+25.6) = 22.3% while its coverage ratio will drop to 2344/(266+180) = 5.3.
- SM's new rating should thus be around **BBB**.

Final vote

All things considered, do you propose the recap? How much debt do you want to issue? How do you think the board will react?

How might the board react?

Bernt Magnusson, chairman

Jan Blomberg, former CEO, Pharmacia

Kenneth Ek, labor rep

Sven Hindrikes, president and CEO

Tuve Johannesson, former president, Volvo Cars

Arne Jurbrant, former CEO, Kraft Foods Nordic

Eva Larsson, labor rep

Joakim Lindstrom, labor rep

Karsten Slotte, president and CEO, Cloetta Frazer

Kersti Strandqvist, business area manager, SCA Baby Care

Meg Tiveus, president, Svenska Spel

How might the board react?

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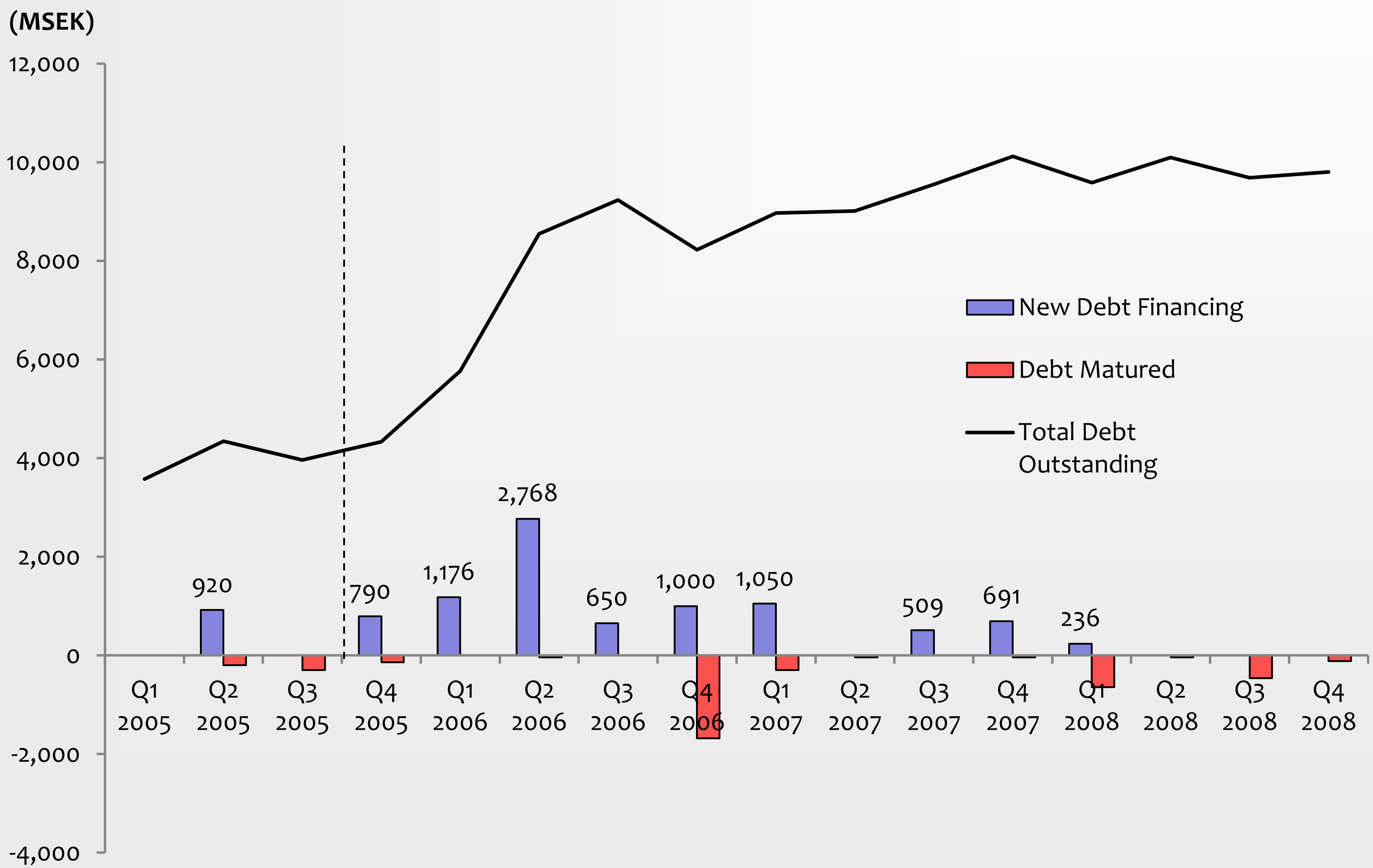
What Happened?

What happened? (1)

- Announced new policy in Fall 2005
    - Target debt: 2x EBITDA
    - Subject to EBITDA interest coverage of at least 9x
    - In between typical values of A and BBB firms

- Bonds were issued under existing Swedish MTN program (SEK) and Global MTN program (EUR)
    - Debt rose from 4,331 MSEK at year-end 2005 to 8,222 MSEK at year-end 2006
    - Net debt rose from 674 MSEK to 3,098 MSEK
    - Accelerated share repurchases

Swedish Match debt 2005-2008

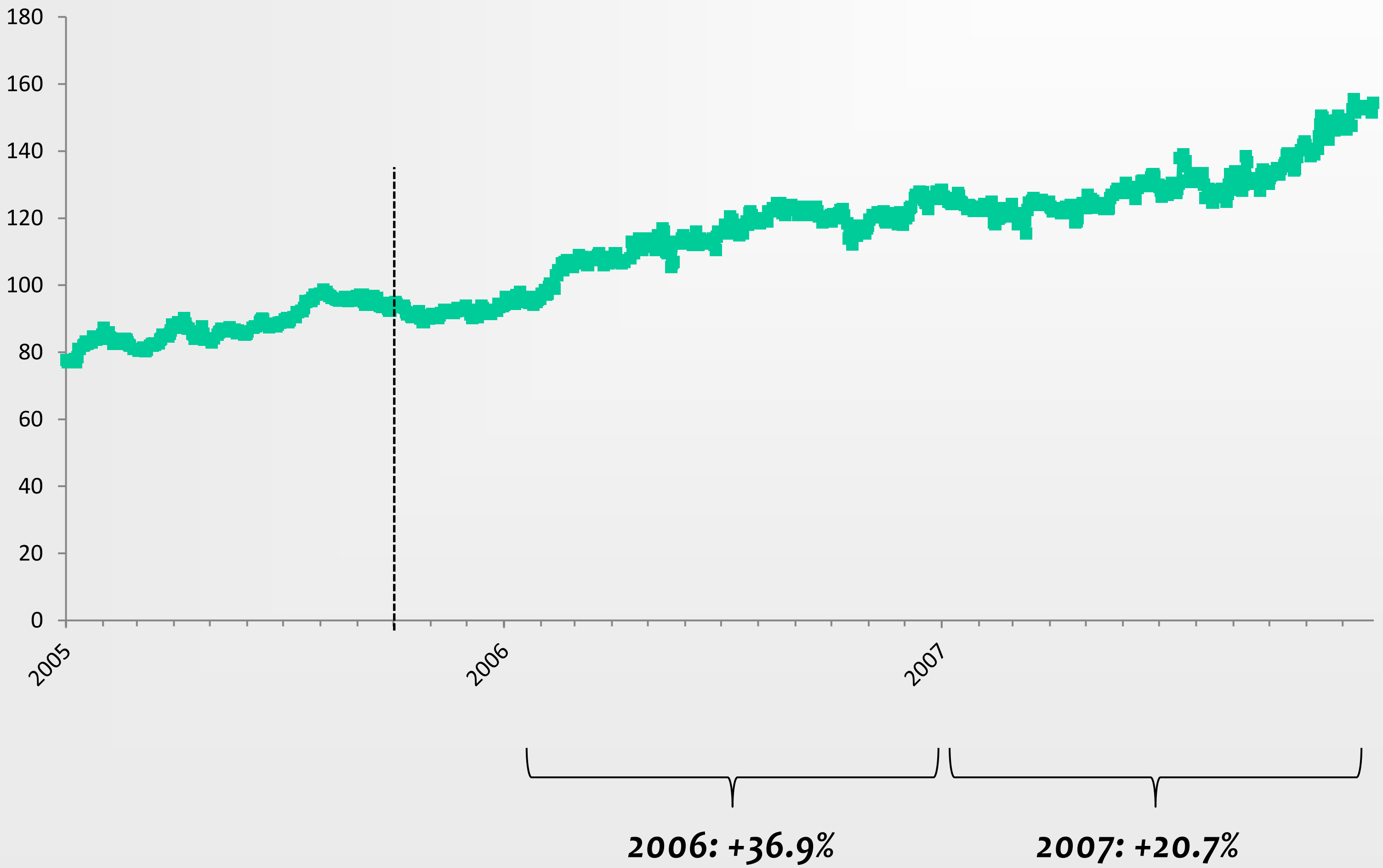


What happened? (2)

- Moody's reduced SM's credit rating from A3 to Baa1 in January 2006
  - Standard & Poor's reduced SM long-term credit rating from A- to BBB+ in October 2006
  - Both firms then downgraded one more notch in late 2007 (to Baa2 and BBB)

- SM's share price did very well in the next few years

Swedish Match
share price, 2005-2007



SWEDISH MATCH

Press release May 13, 2008 8:00 AM

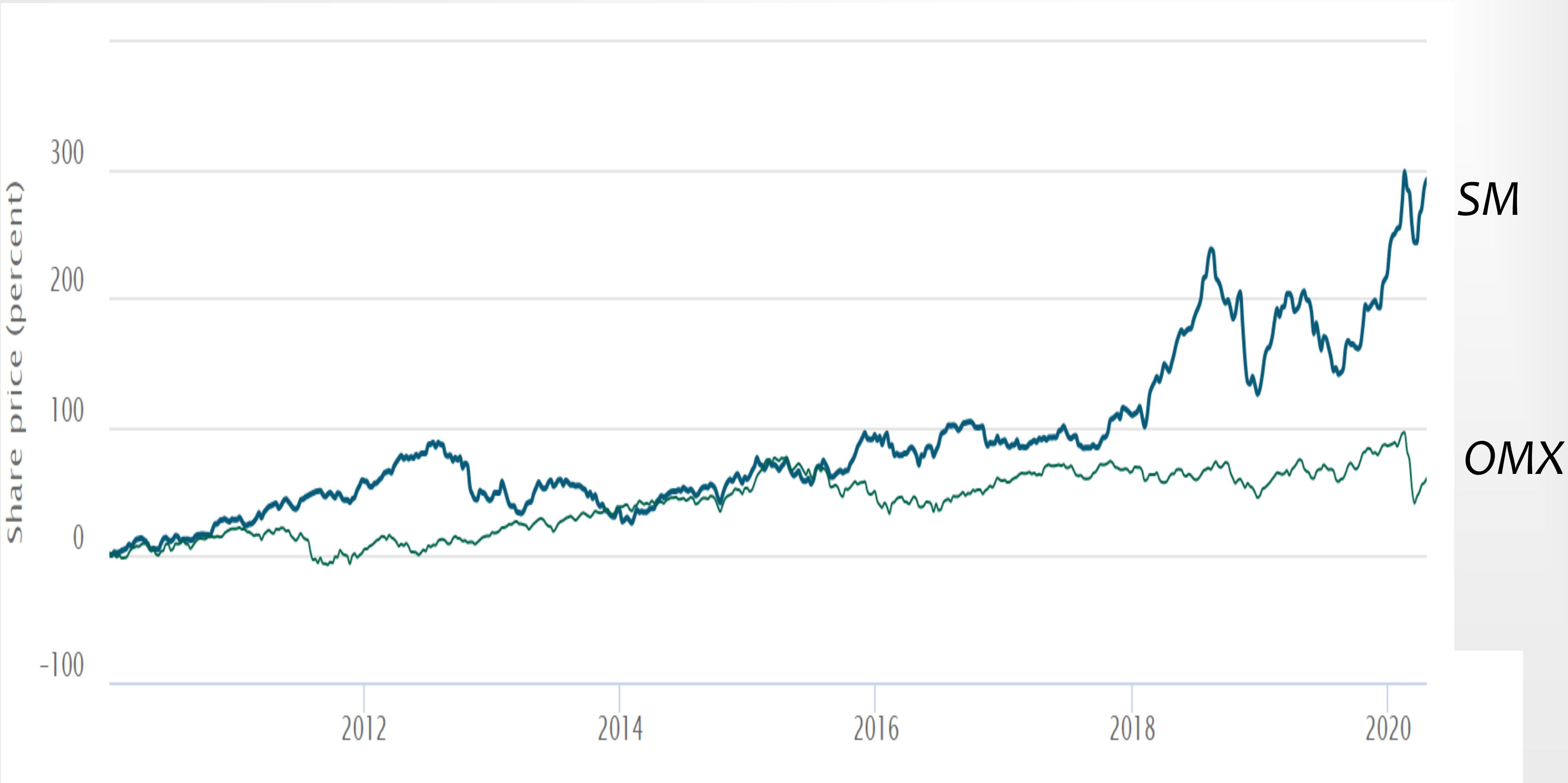
Swedish Match AB appoints new CEO and CFO

The Swedish Match Board of Directors has today appointed Lars Dahlgren, 37, as the new President and CEO of the Swedish Match Group effective June 1, 2008.

Lars Dahlgren joined Swedish Match in 1996 and has held several management positions within the Group, in Sweden as well as internationally. Lars Dahlgren was appointed CFO and Senior Vice President of Swedish Match in 2004. Lars Dahlgren holds a Master of Science in Economics and Business Administration from the Stockholm School of Economics.

Lars Dahlgren and Joakim Tilly

Long-term return: 2010-2020



Take-aways Swedish Match

- Leverage decisions involve *trade-offs* between benefits and costs

- Interest payments reduce corporate taxes -- Debt tax shields

- Simple valuation (if stable debt, constant tax, interest rates): PV(ITS) = $D\tau$

- Tax shields are a *private*, not a social gain: reduce govt tax revenue

- Leverage also has costs: costs of financial distress, borrowing costs, loss of financial flexibility