Case Studies in MODERN CORPORATE FINANCE

ROBERT W. WHITE

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Prentice Hall, Englewood Cliffs, NJ 07632

Library of Congress Cataloging-in-Publication Data

White, Robert W.
Case studies in modern corporate finance / Robert W. White.
p. cm.
ISBN 0-13-288341-4
1. Corporations--Finance--Case studies. 2. International business enterprises--Finance--Case studies. I. Title.
HG4026.W483 1994
658.15'2--dc20 93-46877
CIP

Acquisition Editor Leah Jewell
Production Editor Maureen Wilson
Cover Designer Design Source
Prepress Buyer Patrice Fraccio
Editorial Assistant Eileen Deguzman

Printed in the United States of America
10 9 8 7 6 5 4 3 2 1

ISBN 0-13-288341-4

Prentice-Hall International (UK) Limited, *London*
Prentice-Hall of Australia Pty. Limited, *Sydney*
Prentice-Hall Canada Inc., *Toronto*
Prentice-Hall Hispanoamericana, S.A., *Mexico*
Prentice-Hall of India Private Limited, *New Delhi*
Prentice-Hall of Japan, Inc., *Tokyo*
Simon & Schuster Asia Pte. Ltd., *Singapore*
Editora Prentice Hall do Brasil, Ltda., *Rio de Janiero*

CASE STUDIES
IN
MODERN CORPORATE FINANCE

PREFACE

The materials in *Case Studies in Modern Corporate Finance* draw on the work of many individuals and institutions. The casebook contains cases from Leland Stanford Junior University, Harvard Business School, The International Institute for Management Development, Darden Graduate Business School, INSEAD, Dalhousie University, The Stern School of Business, and the Western Business School, and although a significant number of the cases are U.S. based, the results are substantially international and global. The book contains current cases that focus on the major financial decisions made in a corporation, including such current issues as: globalization; corporate governance; ethics; privatization; securitization; risk management; option pricing; pricing of complex securities; structured financing; value-added taxes; and so on. A detailed categorization of the cases by topic is contained in the preface to the instructor's manual. It has a balanced perspective on the role of commercial banks, their lending practices and financial markets (money markets, capital markets, foreign exchange markets, and derivative securities markets) in financing decisions. The casebook contains forty cases and five notes, and is divided into six parts, each of which builds on the previous parts. The book commences with corporate decisions involving the current portion of the balance sheet and progresses down the balance sheet to decisions with a longer term focus.

Part I, consisting of seven cases and one note, provides students with a framework for analysing cases, the assessment of a firm's performance, and financing needs and loan granting decisions. With the exception of the first case, "John Labatt," the remaining cases have full-fledged computer models to accompany them, enabling the student to develop model building skills.

Part II, consisting of five cases, focuses on short-term financing instruments and decisions: accounts receivable, commercial paper, sophisticated bank facilities, import/export financing, and foreign exchange exposure and management. It provides the student with an introduction to options and forward contracts.

Part III consists of four cases and one note dealing with financial markets. This section starts off by introducing students to the equity markets, the value of information, the efficient markets hypothesis, and ethics via a case on insider trading. The subsequent cases focus on dividend policy, the pricing of securities, the risk return trade-off, option pricing, and the process of bringing securities to market. An innovative financial instrument, instalment receipts, is introduced.

Part IV, consisting of five cases and one note, focuses on the estimation of the cost of capital and investment decisions (capital budgeting). A recent development, the securitization of accounts receivable, is introduced.

Part V, consisting of ten cases and one note, focuses on long-term financing instruments and decisions. The section starts with cases dealing with the attributes of various securities and develops the criteria for selecting between them. This is followed by cases on optimal capital structure and leasing. The section turns to decisions using the financial markets to manage risk: interest rate swaps, commodity swaps, gold options, forwards, and so on. The section ends with a comprehensive case in which students have to formulate a strategy to finance a greenfield (from scratch) pulp mill. Innovative financial instruments, protected index notes, and liquid yield option notes are introduced.

Part VI, consisting of nine cases and one note, covers special topics and integrates material by focusing on measuring the value gap and unlocking value to close the gap. In the process, students are exposed to the role of the board of directors and issues surrounding corporate governance. The first case deals with a fairness opinion for a proposed going private transaction. The perspective of the case is that of a member of the independent committee of the board of directors. Four of the next five cases are merger and acquisition decisions. The last three cases deal with a proxy contest, a privatization, and a post-leveraged recapitalization. The duties and responsibilities of management are important aspects of each of these cases.

Even though the book contains new cases, they have been taught several times to both introductory and advanced students. No matter how well a case is crafted, it is difficult to bring out the "chemistry" of a deal. To supplement the student's learning experience, videos (20 minutes in length) of remarks by the central decision makers, who attended the class when the case was taught for the first time, are available from Western Business School, (519) 661-5267, for a number of the cases.

The care and detail in writing the instructor's manual is a significant strength of the book. Thirty-eight out of the forty teaching notes were written by one person; consequently, they are consistent and follow the same framework. The remaining two teaching notes were consistent with the framework. The teaching notes provide suggested discussion questions. The case analyses are discussion question-based and follow a recommended teaching plan. In today's complex environment issues of corporate governance, the role of the board of directors and constituent groups are particularly important. The cases and teaching notes reflect the philosophy that financial decisions must reflect the corporation as a whole and its environment, i.e., integrate across functional lines and examine all aspects of the decision, both internal and external. A detailed cross-classification of the materials is contained in the preface to the instructor's manual.

The cases and computer models have been classroom tested at both the introductory and advanced course levels. The instructor's manual contains suggested outlines for a number of potential courses. Both the cases and casebook are multi-dimensional, i.e., students at all levels of abilities get involved and are challenged. To illustrate, the Nesbitt Thomson case can be taught at multiple levels: to introduce the valuation of coupon bonds and the risk-return relationship; to introduce the concept that embedded options and securities are bundles of characteristics (convertible debenture); and/or to discuss the valuation of a callable, convertible debenture. Each part of the book starts with a "single" issue case and each subsequent case gets more complex.

Case Studies in Modern Corporate Finance has a unique strategy for developing computer-based model building skills. Where applicable, cases have professionally written computer models to accompany them, included in the instructor's manual. They have been classroom tested and debugged. The strategy is to have the students learn the modelling by example. The intent is to use a "cookbook" approach to develop the students' ability to construct computer-based financial models. Note that these are full-fledged models, *not* templates. The use of these models has the additional benefits of developing the students' analytical skills, depth of understanding of theoretical concepts, and decision making skills.

In sum, this book has a number of distinctive features:

- The cases and casebook are multi-layered, so students at all levels of ability get involved and are challenged.
- The cases are current and focus on the major financial decisions made in a corporation.
- The cases deal with current issues: globalization; corporate governance; ethics; privatization; securitization; risk management; pricing of complex securities; structured financing; value-added taxes; and so on.
- The cases are drawn from a number of international locations.
- The cases and teaching notes reflect the philosophy that financial decisions must reflect both the corporation as a whole and its environment, i.e., integrate across functional lines and examine all aspects of the decision, both internal and external.
- There is a balanced perspective on the role of commercial banks and financial markets (money markets, capital markets, foreign exchange markets, and derivative securities markets) in financing decisions.
- A common theme is the process of deal making: origination; structuring; and placement. In part, the focus is to teach entrepreneurship via examples from one of the most creative fields, investment banking.
- Computer-based financial modelling is integrated into the decision-making process.
- Teaching aids exist for several cases: videos of decision makers, and LOTUS models.
- It includes cases that reflect advances in the theory of finance such as option pricing.
- There is a full spectrum of firm sizes, from the small entrepreneurship to the large multinational corporation.

- A comprehensive instructor's manual is available with detailed discussion question-format teaching notes.

ACKNOWLEDGMENTS

Many people have played a part in the creation of this book and the instructor's manual. Critical to the success of this project has been the participation of business executives who contributed time, insights, and material, much of which is cutting edge and proprietary. To these individuals and their organizations I would like to express my sincere gratitude.

I would like to thank the institutions, authors, and supervisors of the cases from the Western Business School (WBS), Leland Stanford Junior University, Harvard Business School, The International Institute for Management Development, Darden Graduate Business School, INSEAD, The Stern School of Business, and Dalhousie University. The comments and suggestions by several anonymous reviewers and the staff at Prentice Hall were very helpful. I would particularly like to thank Paul Bishop (WBS), Raymond Chan (WBS doctoral candidate), Mark Griffiths (University of Wisconsin at Milwaukee), Leah Jewell (editor at Prentice Hall), Richard Nason (WBS doctoral candidate), Rick Robertson (WBS), Don Thain (WBS), Alasdair Turnbull (WBS doctoral candidate), Maureen Wilson (editor at Prentice Hall), and Ron Wirick (WBS). Mark read both the casebook and the instructor's manual and had a number of good ideas on how they could be improved. Alasdair, a constant source of insights and encouragement, wrote most of the computer models.

The students in the Executive MBA, MBA, and HBA programs at the Western Business School have provided a forum for critical feedback and have been a constant source of encouragement. In addition to the students noted above and/or in individual cases, the following students provided assistance: John Ashby, Michel Bruyere, Vanessa Cato, Scott Dodd, Glen Farrow, Jeff Hawkins, Tom Johnston, Angela Kovich, Katie Nelson, Lani Martin, Bill McLarty and John O'Sullivan.

I would like to thank Bob Merton (then at M.I.T.), Stewart Myers (M.I.T.), Myron Scholes (then at M.I.T.), and Mary Wattum for their generous support at critical times. Last but not least I would like to thank my daughter Alicia. She has had to bear the brunt of the countless hours I spent putting it all together!

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8. COLUMBIA RIVER PULP COMPANY INC.—RECAPITALIZATION

1

JOHN LABATT LIMITED

On September 10, 1992, John Labatt Limited (Labatt) announced a major restructuring with the intention of realizing "hidden value" for shareholders. Under the plan—which would have to be approved by shareholders and various regulatory agencies—Labatt-owned Ault Foods Limited in Canada and Johanna Dairies Inc. in the United States would be spun off into a separate entity run by a separate management team. Labatt's $2 billion dairy operations, built up through several acquisitions in the mid-1980s, accounted for about 48% of its net sales in fiscal 1992. By shedding its dairy operations and focusing on beer and entertainment, Labatt had virtually cut itself in half and closed the book on its spate of acquisitions in the 1980s.

Part of the motivation for this restructuring was to address the poor returns on Labatt's large cash position of about 3% after tax when Labatt's cost of capital exceeded 10%. Other possible reasons were the changing business environment and tough economic times which had made it harder to compete in so many industries without any focus. The company's management finally realized that Labatt's brewing and dairy operations were different businesses with different operational needs. They decided to focus on beer and entertainment, because that's where they thought Labatt could prosper. Indeed, Labatt's dairy operations were the least profitable among its three business segments (Exhibit 1). Segmented earnings as a percent of net assets employed in 1992 for Dairy, Brewing and Entertainment were 9.9%, 22.7% and 41.4%, respectively. Dairy sales had been nearly stagnant over the period 1987 to 1992, whereas revenue from the entertainment segment was up sharply and Labatt's brewing sales were growing both domestically and abroad.

Speculation, which had started in 1991, about Labatt being up for sale by Brascan Ltd., which had a 37% controlling interest in Labatt, was still going on. By repackaging the company, Labatt, comprised of brewing business, entertainment business and liquid assets, would be more attractive to a number of foreign brewers seeking to establish a foothold in North America. Anheuser-Busch Cos. Inc. (A-B) of St. Louis, U.S., the world's largest beer maker, was at the top of a list of companies that might be counted on to bid for Labatt. A-B had announced a number of management and organizational changes that appeared to position A-B to make foreign acquisitions. A-B and Labatt had long been viewed as an almost perfect fit, because they were both in the beer and entertainment businesses. Labatt had interests in sports broadcasting, entertainment promotions companies and the Toronto Blue Jays baseball team, while A-B owned the St. Louis Cardinals baseball team and operated theme parks in the U.S. and other countries. In addition, the two companies already had established relationships—Labatt produced Budweiser under license from A-B. On the other hand, some analysts believed that A-B did not have to spend $1.5 billion to gain access to the Canadian markets because free trade in beer would sooner or later become a reality.

Labatt's management stated the following rationale for selecting this alternative among others to increase shareholder value:

1. It allowed the direct valuation by the market of its business segments, with better interpretation of the operating results.
2. An organizational layer could be removed in the process.
3. It would increase accountability for the respective company's management, which is useful for senior management motivation and compensation.
4. It might result in greater capital market discipline (perhaps even lead to reducing the net cost of capital).
5. It would provide greater focus.
6. This alternative was more tax efficient than selling these assets.

From a shareholder's perspective, how well had Labatt performed and what were Labatt's prospects?

BACKGROUND ON THE COMPANY

In 1847, Messrs. Labatt and Eccles purchased from John Balkwill a small brewery located in London, Ontario. The business was incorporated on December 20, 1930 under the name of John Labatt Limited. From 1946 to the early 1960s, the company, by making a number of acquisitions of breweries in Toronto, Winnipeg, Montreal, Vancouver, and St. John's, established its presence across Canada. A more complete corporate re-organization was effected during 1964 because of the broadening of the company's operations. After the change, Labatt became a holding company for its subsidiaries. The company entered into the pharmaceutical field, but subsequently abandoned it in 1967. Labatt started its interest in the food sector in 1968 when it bought Ogilvie Mills Ltd., which produces flour and starch products. During the 1980s, the company aggressively increased its portfolio of food products through acquisitions in Canada and the U.S. It was not until the mid-'80s that the company began to invest in the entertainment business. As of September 1992, Labatt consisted of three segments: Brewing, Dairy, and Entertainment.

BREWING GROUP

This group produced and marketed 35 different brands of lager and ale for sale in Canada, U.S., U.K., Italy and 17 other countries. Its most popular brands included Labatt Blue, Blue Light, 50, Genuine Draft and Budweiser (brewed under license from Anheuser-Busch). Group sales amounted to $1,564MM or 39% of 1992 total sales of Labatt. Segmented earnings were $181MM or 60% of Labatt's earnings.

There were three divisions in this group: (1) Labatt Breweries of Canada operated 11 breweries across Canada with an aggregate annual capacity of approximately 10.6 million hectolitres. During fiscal 1992, Labatt Canada's sales accounted for 42.3% of the national market share. (2) Labatt's USA operated in the high-quality segment of the U.S. beer business. The division produced and marketed the Rolling Rock brand from its Latrobe Brewing plant. The division also imported and marketed selected Labatt brands from Canada, the Birra Moretti brands from Labatt's Italian breweries and other international brands. (3) Labatt Breweries of Europe had two operating components: Labatt U.K., which operated in the United Kingdom, and Birra Moretti, which was based in Italy. Labatt U.K. distributed the Labatt's Canadian Lager and Rolling Rock brands within the United Kingdom through Maple Leaf Inn Ltd., a joint venture with Pubmaster, an independent pub retailer. Birra Moretti brewed several beer brands for sale in Italy and for export to other countries.

DAIRY GROUP

This group was named "Food Group" in fiscal 1991. During fiscal 1992, the company disposed of all of its non-dairy businesses and raised its stake in dairies. In August 1991, JL Food, a major frozen soup and pizza supplier to the hotel and restaurant industry based in Eugene, Oregon, was sold to H.J. Heinz Co. of Pittsburgh for about $600MM. In January 1992, Labatt sold its Everfresh fruit juice and drinks business to a group of U.S. investors. Three months later, Ogilvie Mills companies, which produced and distributed flour, starch, pizza and livestock feed, were sold separately to Canadian and U.S. investors. After these divestitures, the operations that remained were two main divisions in the dairy industry: Ault Foods and Johanna

Dairies. In fiscal 1992, the group's sales totalled $2,110MM or 52% of Labatt's sales. Segmented earnings were $62MM or 21% of Labatt's earnings.

Ault Foods was one of Canada's largest integrated dairy operations. It produced and marketed a full line of dairy and industrial milk products, including cheese, butter, skim milk, yogurt and ice cream, primarily in Ontario and Quebec.

Johanna Dairies was the largest table milk processor in the north eastern United States. Its customers included supermarket and convenience store chains, wholesalers, independent grocery stores and many food service accounts. The primary distribution areas were Metropolitan New York, New Jersey, Pennsylvania, Maryland and the District of Columbia.

ENTERTAINMENT GROUP

This segment comprised three divisions: the JLL Broadcast Group, the Toronto Blue Jays Baseball Club and the John Labatt Entertainment Group. In fiscal 1992, group sales were $374MM or 9% of Labatt's total sales. Segmented earnings were $58MM or 19% of Labatt's earnings.

The JLL Broadcast Group was a television broadcasting and production operation. Its business included TSN, an all-sports television service; RDS, a French-language counterpart to TSN; TSN Enterprises, a supplier of broadcast support and ancillary services; Dome Productions, a television production and video post-production facility; and Skyvision Entertainment, a television program producer.

In fiscal 1992, Labatt acquired an additional 45% interest in the Toronto Blue Jays, an American League baseball club, bringing its ownership to 90%.

John Labatt Entertainment Group comprised both marketing and entertainment services business. Supercorp Entertainment provided services to the advertising industry, primarily in the areas of commercial film productions, media planning and buying, animation, audio recording and post-production. JLL Entertainment was a live-event promoter and a merchandiser of related apparel.

THE BUSINESS ENVIRONMENT

Since Labatt owned such a diverse portfolio of businesses, each sector was being affected differently by the environment and faced different challenges from its competitors.

The Brewing Industry

The brewing industry in Canada was operating in a nearly saturated market. Gains on market share were usually obtained through introducing new products. In the past, cutting costs and lowering prices had been constrained by interprovincial barriers which prohibited the sale of beer produced in other provinces. The big breweries had to set up relatively small plants in each of the provinces. Recently, however, under the pressure of the Free Trade Agreement and GATT talks, several