Marriott case solution

Business

MarriottCorporation, with its comparative advantage in hotel development and management, has expected excellent future growth and profitability. Such increase in sales might bring in extra cash flow, resulting in underutilized debt capacity.

Therefore, we have performed a thorough analysis on the proposal of increasing debt ratio and repurchase the shares. In 1974, Marriot Corporation was in a situation where it had limited access to a few funding resources. A significant amount of short maturities debt is used to finance the company. This financing approach put a heavy debt burden on Marriott, resulting in huge amount of debt repayments. Upon figuring out such heavy debt issue, Marriot broadened its potential lenders, opened up the financial market, refinanced with long term debts as well as to change financial policy to lower the leverage. In 1975, Marriott shifts its hotel strategy from ownership to leasing and management contracts where they have a comparative advantage.

Besides, Marriott has more opportunities than its chain competitors and individuals to accelerate the planned annual hotel growth because they were able to obtain financing for new hotels. So its business strategy was to keep on implementing the investment improvement strategy to where it had comparative advantages by building up the attendance of 2 Theme Parks and shifting from hotel ownership to outside ownership and management contracts. By doing so, it expected the profitability to increase from 6. 6% in 1979 to 8. 7% in 1983 and the ROE to increase to 20% by 1983.

Since Mariott Corporation’s performance has been exceptional after the improvement program initiate in 1975, the company has increase its equity base through retention of retained earning without increasing any of its debt. The debt ratio fell below 20% which is only half on the financial policy guidelines proposed by Gary Wilson in 1978. Thus, Mr. Wilson has expressed concern about the firm’s unused debt capacity and low leverage ratio. In his opinion, he finds that unused debt capacity is imprudent in inflatory environment and the company should immediately raise its debt to equity ratio in order to take advantage of the rising interest rate.

He further discussed his reasoning as the following; * Cost of Debt is significantly lower than cost of equity. Since the cost of capital is small, there will be more left over for common shareholders. * Coverage impacts firms’ credit rating. Highly rated firm usually have high rating simply because they have limited reinvestment which does not reflect a prudent decision in financial policy. Basically, Mr. Wilson’s viewpoint is for Mariott to have a high leverage ratio to approximately 40-45% and since the company is doing exceptionally well, it should not affect the firm’s ability to pay its obligation in the future while maximizing benefit from unused debt capacity.

Mr. Wilson’s opinion is partly correct and partly incorrect. It is correct that the required return for debt is lower than the required return on equity simply because debt holders have priority in cash flow and fixed promised stream of cash flow. However, when the firm increases its’ debt, the cost of equity increases as well due to the higher risk bear by equity holders. Althought it does not change the cost of debt term in weighted average cost of capital of the company, it increases the cost of equity term in the formula.

Furthermore, coverage and bond rating is not the only two items that increasing leverage affects.

It also effect the cost of financial distress such as tax on investment. For instance, if the firm is at its limit on debt-equity ratio and it faces with a positive NPV project, the firm might not be able to take it because the shareholders need to provide the excess capital without getting the full-sized profit. For the repurchase plan, a $4 premium on a share price of $19. 625 is equivalent to a 20. 4% premium, at 23. 625.

In order for that price to be justified (maintain the same P/E ratio at purchase) of 10, earnings would have to grow to 2. 36 per share, while the pro forma income statement states $2. 14 per share. However, average analysts eps for 1983 is 3. 38 / share. Thus, with the original number of shares outstanding, analysts are projecting earnings of a total of 108.

498 million. After the proposed buyback of 10m shares, total earnings per share would be 4. 91 at that level of total earnings. P/E at that eps and at the buyback price is 4. 811 (23.

625/4. 91). That is less than half of the P/E of the shares before buyback at 1980, which indicates that premium is fair. For the trade off face by the firm, Marriott had multiple issues to consider. One was the potential breach of the debt covenants, so they need to be renegotiated before the repurchase.

Second, the increase in debt load might increase the WACC, prompting investors to require a higher rate of return. The new debt may cause a debt overhang, prohibiting Marriott from investing in new projects and putting the firm in jeopardy of insolvency.