

Ust case study essay sample

Finance



1. Assess the business and financial risks of UST

Business risks are relatively low:

Main risk is that UST has undiversified business, it basically relies on one product. However, its main product is noncyclical, it carries little systematic risk. Imminent increase in excise tax on smokeless tobacco (however, tobacco demand is considerably inelastic). It is the (sub)industry leader (market share > 85%), industry is an oligopoly which implies high barriers for potential competitors to enter the market.

Financial risks are even lower:

Cash flows are constantly increasing

Profit margins are high

Outperforms comparable firms

No leverage

Forecasts are positive

2. What are the benefits of debt in UST's case?

Debt tax shield: increase in debt results in lower taxable income and thus less taxes. Reduction in agency costs: higher interest payments reduce the free cash flow available to firm's management. Consequently, less money can be 'overspent' in investments with positive utility for management, but negative NPV for shareholders. Tightening of free cash flow margin may induce management to increase financial efficiency.

3. Exhibit 4 provides pro forma debt/total capital ratios. What interest rate do you expect UST to have to pay at these various debt levels? (Assume that if

UST issues debt, it uses the proceeds to buy back equity). The highest debt level in the exhibit is 30%, you may want to look at 50 and 80% as well. At each debt level, try to estimate what bond rating the UST debt would have and what interest rate that would correspond to. Use the data on bond ratings and key financial ratios as a guide.

The interest rate that UST is expected to pay depends on the rating of its debt, this in turn depends on the level of debt since the higher the level of debt the higher the probability of UST defaulting. Although it is not explicit how rating agencies assess the creditworthiness of companies, we can attempt to estimate the rating of UST's long-term debt based on observed ratings. To keep things easily tractable, consider only interest coverage in this assignment. Start by plotting yields (ratings) of other firms on their interest coverage ratios.

Next find out the interest coverage ratio for a given level of debt, for every possible rating assigned to it. Compare the resulting combinations of interest coverage and debt yields with ones of the peer firms that were previously plotted, then find the one that matches most closely.

4. What are the costs of debt? For example, should management worry about the possibility of bankruptcy? Are the costs of financial distress likely to be high or low for UST?

Costs of debt stem from the increase in the probability of the firm defaulting. As soon as the firm cannot service its debt repayments, it is in a situation of financial distress. The expected costs of financial distress are equal to the product of the probability of financial distress and the costs given financial
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distress Probability of financial distress is mainly a function of the volatility of future cash flows and level of leverage Costs given financial distress may be direct (bankruptcy costs) or indirect Firm may have to pass on profitable investments due to lack of funding Loss of key stakeholders

Fire sales

Aggressive behavior of competition

Costs of financial distress for UST seem to be low

The current and forecasted financial position seems to be more stable than competition Few investment opportunities (if any)

UST's business model does not seem to rely on customer care, suppliers, or human capital UST does not have a lot of tangible assets that could be sold at a high discount UST's competition is limited

5. At each debt level, estimate the benefits of debt. Also, for each debt level, do a back-of-the-envelope calculation of how big the value lost in financial distress has to be for that debt level to be optimal for the firm.

6. UST Inc. has paid uninterrupted dividends since 1912. Will a recapitalization (issuing debt and buying back equity with the proceeds) hamper future dividend payments?

In order to check what happens to dividends per share, we need to examine the effect of leverage on the number of shares The new number of shares outstanding will be equal to the older number of shares minus shares repurchased MM irrelevance proposition does not hold for the case of taxes, we need to first estimate the new share price Assuming a semi-strong form

of market efficiency, the value of equity, and thus the share price, will adjust to the new information upon announcement of the debt issuance. For simplicity, assume that the market value of debt = face value of debt. After the debt issuance but before the share repurchase, the value of the assets will be equal to $V_L + C = V_L + D$. Thus $E = V_L$.