

Debt policy at ust inc.: overview

Business, Company



Executive Summary Holding nearly 80% of the market share in the smokeless tobacco industry, UST Inc. has been generating large and stable income. However, the leading company in a certain industry tends to react slowly to market share erosion by competing firms and lack of creativity in the introduction of new product, a situation UST Inc. is now undergoing. Concerning the declining sales growth and gradual loss of the market share, UST Inc. is now considering recapitalizing by issuing debt amounts to \$1 billion.

By recapitalizing, it can create a total \$380 million interest tax shield to add up firm value and, at the same time, make shareholders better off by using the proceeds from the issuance of debt to buyback outstanding shares. Although declining sales growth and litigation problem might be hidden concerns for UST Inc. , after some analysis about the attributes of the company such as business risk, capital structure as well as payout policy, I still believe that UST Inc. s heading toward the right direction. And we can also observe that, after the adjustment of capital structure, its traditional dividend payout policy will not be hampered in the near future. Analysis of Business Risks (from bondholder's viewpoint) Bondholders only care about the ability of the company to make interest payments and whether they can get the face value when the bond matures. Therefore, we have to consider the factors that contribute to the amount and stability of future EBIT.

In the situation of UST, several factors have more of an impact on the company's business risk, such as sales growth, competition faced owing to other competitors' erosion into their market share and the effect of litigation problem and government regulations. Since the smokeless tobacco are

considered less harmful to health and increased prevalence of smoking bans, demand of smokeless tobacco has undergone a continued growth, which would contribute good prospect to UST since its products strategy focus primarily on smokeless tobacco.

However, as a dominant player in the industry, UST seems to be less creative on the introduction of new product and react too slowly to other competitors' erosion into their market share. So far, UST has been increasing the price of their product as a way to boost their annual earning, which gives other players a perfect chance to gain some market share by using price value strategy. Despite the steady decline of market share might turn into future concern for UST, it still holds 77% of the market share. Besides, UST has started to make effort in new product development and renew their marketing and promotion strategy.

On the other hand, although litigation and legislation problems have impacts on sales of UST, these problems has been there for a long time, which means that it shouldn't create new turbulence on the prospect of UST. To conclude, the attributes of UST are steadily growing EBIT (approximately 9% compounded), dominant market share in the industry. Therefore, although there are some disadvantages toward their future earning power, such as increasing competition and litigation problems, bondholders shouldn't care too much on them since the interest expense is still a minor portion of the total EBIT.

The Timing of Recapitalization It is publicly known that, through leverage, companies can lower their WACC and receive benefit from interest tax shield in order to boost their firm value. This is exactly what UST Inc. is doing right

now. By issuing debt and use the fund to buy back outstanding shares, it is boosting their stock price higher. I reckon that the reason they choose to do so at this specific time is because the company has been facing more and more vigorous competition these years and undergoing declining rate of sales growth.

By adopting leverage recapitalization, UST can still make the stockholder better off even its sales growth is not high enough. Besides, UST's debt to asset ratio is currently at a low level compare to other competitors in the industry. Therefore, they can adopt the recapitalization strategy without worrying too much about the default risk problem. Capital Structure after the Recapitalization From the pro forma income statement (exhibit 1) in the appendix, we can see that even if the bond is issued at a rating of BBB (higher cost of debt), the EBIT/interest coverage ratio is still 10. 21, which shows that UST as sufficient amount of EBIT to make the interest payments. And the marginal effect on UST's firm value would be the total debt (\$1 billion) multiplied by the corporate tax rate (38%), which is \$380 million. Dividend Payout Policy From Exhibit 2, we can observe that, under current condition, the payout ratio is around 63%, which is the percentage UST has long been paying out in the past. Therefore, it is safe to draw the conclusion that the recapitalization will not hamper future dividend payment under current condition. However, we are not sure whether the market share and the growth of sales will continue to drop.

If they do, it will become more and more difficult for UST to stick to their traditional “pleasing” payout policy. Likely, we are not sure whether the litigation problem will be more of a concern for UST in the future. Ultimately,

despite the fact that the opponents' erosion into UST's market share and litigation problem are both hidden concerns, it takes time for both problems to pose a threat to UST's traditional payout policy. Appendix Exhibit 1 Pro Forma Income Statement Exhibit 2 Dividend Calculation after the Buyback Program CorporateFinanceCase StudyAssignment Debt Policy at UST Inc.