Capital structure for diageo essay sample

Finance

Introduction and Background

Diageo was formed in 1997 through the merger of two consumer product companies Grand Metropolitan plc and Guinness plc under the strategy of reducing costs through marketing synergies, cutting overhead expenses and increasing production and purchasing efficiencies. The new merger wanted to concentrate solely on the beverage alcohol business, so it sold its packaged foods (Pillsbury) and fast food (Burger King) businesses. While the mandate for Managing for Value came from the highest levels of Diageo, the treasury team was given the task of establishing the cost of capital for each of the different areas the company operated. The team had to create a simulation model which should consider new finance approaches, treasury functions to focus on, what the firm’s risk footprints will be, how to calculate cost of capital and finally how to optimally structure capital.

How has Diageo managed its capital structure?

Both Grand Metropolitan and Guinness had little debt prior to the merger, which allowed them to benefit from relatively high ratings on their bonds (AA and A respectively). Straight after the merger, Diageo’s management announced it would maintain similar policies to the ones adopted by the two previous companies. This decision took the form of an implicit promise not to get into a debt level that would lead to a reduction in the credit rating of the company, which was aiming at an interest coverage between 5 and 8. A second target was set to keep EBITDA/Total Debt at 30%-35% level. This tranquilized investors and financial markets and as a consequence the company was given an A+ rating by credit agencies.

Table 1 presents some key financial indicators extracted from the case. As it can be observed, Diageo's debt level is low (market gearing level is around 25%), which together with the favorable credit rating (A+) puts the company in a good borrowing position in case of such need. From the data shown in Table 2 we can see that the company's good interest coverage ratio (EBITDA/Interest payable) is mainly due to high EBITs over the years (40 million in 2000) compared to the interests to be paid (3 million in 2000).

As we can observe in Table 1, Diageo is fulfilling the implicit promise it has made to the public maintaining the EBITDA/Total Debt ratio within the 30%-35% interval (34% in 2000) and the interest coverage value between 5 and 81. It can be noticed though that in both indicators Diageo has reached the promised limits and an eventual decrease in the company's EBIT next year could lead to an interest coverage below 5, which would have as a consequence a downgrade of the company's credit rating. On the other hand, having an EBITDA/Total Debt ratio around 34% means that the company is either reducing its total debt thus not taking full advantage of its tax shield or increasing its EBITDA, which results in paying more taxes.

1 For our calculations in table 2 we used EBIT/Total Debt since there was no information about depreciation and amortization in Diageo's Financial Statements, and consequently in 2000 the interest coverage we obtained was 4. 79 rather than 5 as shown in Exhibit 4 of the case.

Table 1. Diageo's financial data for 2000

Table 2. Financial Statement Data between 1997 and 2000

What does the Equilibrium Theory argue? How would you apply this theory to Diageo? What capital structure would result?

The Equilibrium Theory argues that the value of the leveraged value of a company depends on the un-levered (full equity) value of the firm plus the present value of the tax shield minus the present value of the distress costs. The present values of tax shield and the distress costs vary with different levels of debt. Debt does not affect the un-levered value of the firm due to the fact that debt finance does not affect the operating risk of the company, but it does affect the financial risk. As the leverage increases the expected return from equity holders also augments along with risk. These effects cancel out making the shareholder value unmoved. But it is important to note that as a firms borrows more, the risk of default increases, making the company pay higher interests rates on new debt. There is a point in the D/E ratio (usually high) where holders of the risky debt begin to bear part of the firm’s operating risk. This happens because as the company acquires more debt, more of that risk is relocated from stockholders to bond holders.

The advantage of debt financing is that interests paid on such debt are tax deductible. If a company has the intention of maintaining a permanent debt, the present value of the tax shield can be obtained by discounting them by the expected rate of return demanded by the investors who hold the debt (this is a perpetuity, where in reality would be the maximum possible present value for the tax shield). This tax shield value reduces the tax bill and increases the cash payment to investors, increasing the value of their investments.

It seems then that companies should fully leverage the company or a least come close to doing so but there is a probability that the company enters financial distress as its leverage (D/E) increases. Financial distress can be very costly for companies, and the cost for this scenario is shown in the current market value of the levered firm’s securities. Investors factor the potential for future distress into their assessment of the present value (this is where PV of distress costs is subtracted from un-levered company value and the PV of the tax-shield.) The value for the costs of financial distress depends on the chances of falling into distress and on the costs the company would incur if found in such situation. At reasonable debt levels the probability of financial distress is small and the tax-shield advantages are higher. But as the leverage increases from a certain point, the potential costs of distress increase fast and these costs reduce the value of the company.

Diageo has used a low-levered capital structure in the last 4 years, with a average D/V ratio of 23%. The probability of the company entering in financial distress at these levels of D/V ratios is low. This can be seen by the A rating the company has had during the last 3 years (98, 99, 00) resulting in a debt holders’ expected return of 8. 0%.

Diageo has had a steady positive and increasing net income in the last 3 years, the corporate tax rate that the company is being charged is high (Table 2 – Taxes/EBT was 45% in 1998 and 29% in 2000) and it has low risk tangible assets (factories, liquid inventory, etc). Therefore, according to the Equilibrium theory, Diageo has a big leverage capacity. It seems that management at Diageo prefers to maintain the low debt leverage by using internal financing in order to have larger flexibility and control within the

company. By maintaining a low debt level and high rating, management at Diageo can use its capability of acquiring debt at low rates for important events, such as strategic takeovers or investments. It is important to note that Diageo has decreased the number of outstanding shares during 98, 99, and 00. This strategy also points out to the importance of control for the company’s management. The capital structure which Diageo should look for is one which decreases the probability of financial distress and maximizes the value of the tax-savings due to additional borrowing. In another words, when PV of tax-shield is just counterbalanced by increases in PV of financial distress costs.

Using the data provided by the model presented in the case, what capital structure would you recommend to Diageo?

According to the Equilibrium Theory, Diageo should adopt a capital structure such that the present value of the tax savings equals the present value of the bankruptcy costs. According to the output of the simulation model the point where this happens is where EBIT/Interest equals 2. 8.

Although the Equilibrium Theory points in this direction there are other factors that Diageo management should take into consideration when analyzing this issue. An interest coverage of 2. 8 corresponds to a very high debt level which results in Diageo being downgraded to BBB. In this sense Diageo will be subject to very high annual interest payments, which could ultimately (if that level is reached) lead to paid interest being higher than EBIT and consequently the company not taking full advantage of the tax shield (interest coverage lower than 1).

Another key issue linked to this loss of financial flexibility due to the increase in leverage is that it may result in the loss of opportunities, such as, not being able to invest in new projects, obtain financing for acquisitions (an important growth strategy in this industry) or even pay dividends. As a consequence we would argue that Diageo should not make full use of its borrowing capacity in order to keep a reserve source of funds in case it is need.

Hence based on the model output data we would suggest that Diageo adopts a capital structure that allows the company to achieve a interest coverage ratio of 4. 2 which would lead the company to a rating of A- or maybe even A (due to the stable nature of Diageo’s portfolio of brands) while benefiting from a higher tax shield than it does at the present moment.

Critique the model presented in the case. Does it incorporate all the important risk factors faced by Diageo? If not, how would you adjust the model so that it does?

Diageo designed a Monte-Carlo simulation model in order to find which financial policy (capital structure) would fit best the future goals of the company. The financial team who was in charge of the creation of this simulation had no trouble in modeling the tax deductibility of interest on debt. Instead they found it more difficult to model the costs of financial distress.

The simulation calculated EBIT as a fraction of assets, based on three unknown items: ROA for each geographical region, exchange rates, and interest rates paid on debt. Earnings and interest payments determined the

amount of taxes paid and the coverage ratio. Here the tax-shield value and the new interest rates the company would have due to the changing coverage ratio are being taken into account which is correct. The simulation model would assume financial distress once the coverage ratio was less than 1. This also is a correct assumption because when the coverage ratio is less than one that means the company is having trouble paying its financial debts (EBIT is less than interest payments). Once this happens distress costs augment which means a 20% reduction in the value of the firm. This distress costs seems a little high, but assuming a worst-case scenario is better than being to optimistic.

A small glitch that this model seems to have is not taking into account the option of selling more shares in order to pay debt to recover from a coverage ratio smaller than 1. Also this glitch disables the evaluation of raising funds in the scenario of a strategic acquisition or project investment. It would be interesting to see how this possibility would affect the results and capital structure of the company. The company had an aimed coverage ratio range, which the simulation adjusted by paying out dividends if there was extra cash, but in the situation of cash shortfall, the model took on new debt to attend the deficit. This model does not include the possibility of selling current assets in order to attend deficit problems.

The team took into account local EBIT (assets x ROA), interest rates (based on different possible ratings), foreign exchange fluctuations, and market correlations (assumed that correlations were constant between random variables) as risk factors. This model seems to cover the most important risk factors that Diageo might face.