

Blaine kitchenware, inc.: capital structure



On April 27, 2007, Victor Dubinski, CEO of Blaine Kitchenware, Inc. (BKI), sat in his office reflecting on a meeting he had had with an investment banker earlier in the week. The banker, whom Dubinski had known for years, asked for the meeting after a group of private equity investors made discreet inquiries about a possible acquisition of Blaine. Although Blaine was a public company, a majority of its shares were controlled by family members descended from the firm's founders together with various family trusts.

Family interests were strongly represented on the board of directors as well. Dubinski knew the family had no current interest in selling—on the contrary, Blaine was interested in acquiring other companies in the kitchen appliances space—so this overture, like a few others before it, would be politely rebuffed. Nevertheless, Dubinski was struck by the banker's assertion that a private equity buyer could “unlock” value inherent in Blaine's strong operations and balance sheet. Using cash on Blaine's balance sheet and new borrowings, a private equity firm could purchase all of Blaine's outstanding shares at a price higher than \$16.25 per share, its current stock price. It would then repay the debt over time using the company's future earnings. When the banker pointed out that BKI itself could do the same thing—borrow money to buy back its own shares—Dubinski had asked, “But why would we do that?” The banker's response was blunt: “Because you're over-liquid and under-levered. Your shareholders are paying a price for that.” In the days since the meeting, Dubinski's thoughts kept returning to share repurchase. How many shares could be bought? At what price? Would it sap Blaine's financial strength? Or prevent it from making future acquisitions?

Blaine Kitchenware's Business

Blaine Kitchenware was a mid-sized producer of branded small appliances primarily used in residential kitchens. Originally founded as The Blaine Electrical Apparatus Company in 1927, it produced then-novel electric home appliances, such as irons, vacuum cleaners, waffle irons, and cream separators, which were touted as modern, clean, and easier to use than counterparts fueled by oil, coal, gas, or by hand.

By 2006, the company's products consisted of a wide range of small kitchen appliances used for food and beverage preparation and for cooking, including several branded lines of deep fryers, griddles, waffle irons, toasters, small ovens, blenders, mixers, pressure cookers, steamers, slow cookers, shredders and slicers, and coffee makers.

Blaine had just under 10% of the \$2.3 billion U. S. market for small kitchen appliances.

For the period 2003–2006, the industry posted modest annual unit sales growth of 2% despite positive market conditions including a strong housing market, growth in affluent householders, and product innovations. Competition from inexpensive imports and aggressive pricing by mass merchandisers limited industry dollar volume growth to just 3.5% annually over that same period. Historically, the industry had been fragmented, but it had recently experienced some consolidation that many participants expected to continue. In recent years, Blaine had been expanding into foreign markets.

Nevertheless, in 2006, 65% of its revenue was generated from shipments to U. S. wholesalers and retailers, with the balance coming from sales to <https://assignbuster.com/blaine-kitchenware-inc-capital-structure/>

Canada, Europe, and Central and South America. The company shipped approximately 14 million units a year. There were three major segments in the small kitchen appliance industry: food preparation appliances, cooking appliances, and beverage-making appliances. Blaine produced products for all three, but the majority of its revenues came from cooking appliances and food preparation appliances.

Its market share of beverage-making appliances was only 2%. Most of BKI's appliances retailed at medium price points, at or just below products offered by the best-known national brands. BKI's market research consistently showed that the Blaine brand was well-known and well-regarded by consumers. It was associated somewhat with "nostalgia" and the creation of "familiar, wholesome dishes." Recently, Blaine had introduced some goods with "smart" technology features and sleeker styling, targeting higher-end consumers and intended to compete at higher price points.

This strategy was in response to increased competition from Asian imports and private label products. The majority of BKI's products were distributed via a network of wholesalers, which supplied mass merchandisers and department stores, but its upper-tier products were sold directly to specialty retailers and catalog companies. Regardless of the distribution channel, BKI offered consumers standard warranty terms of 90 days to one year, depending on the appliance. Blaine's monthly sales reached a seasonal peak during October and November as retailers increased stock in anticipation of the holiday season.

A smaller peak occurred in May and June, coinciding with Mother's Day, a summer surge in weddings, and the seasonal peak in home purchases.

Historically, sales of Blaine appliances had been cyclical as well, tending to track overall macroeconomic activity. This also was the case for the industry as a whole; in particular, changes in appliance sales were correlated with changes in housing sales and in-home renovation and household formation. BKI owned and operated a small factory in Minnesota that produced cast iron parts with specialty coatings for certain of its cookware offerings.

Otherwise, however, Blaine, like most companies in the appliance industry, outsourced its production. In 2006 BKI had suppliers and contract manufacturers in China, Vietnam, Canada, and Mexico. Victor Dubinski was a great-grandson of one of the founders. An engineer by training, Dubinski served in the U. S. Navy after graduating from college in 1970. After his discharge, he worked for a large aerospace and defense contractor until joining the family business in 1981 as head of operations. He was elected to the board of directors in 1988 and became Blaine's CEO in 1992, succeeding his uncle.

Under Dubinski's leadership, Blaine operated much as it always had, with three notable exceptions. First, the company completed an IPO in 1994. This provided a measure of liquidity for certain of the founders' descendants who, collectively, owned 62% of the outstanding shares following the IPO. Second, beginning in the 1990s, Blaine gradually moved its production abroad. The company began by taking advantage of NAFTA, engaging suppliers, and performing some manufacturing in Mexico. By 2003, BKI also had established relationships with several Asian manufacturers, and the large majority of its production took place outside the United States. Finally, BKI had undertaken a strategy focused on rounding out and complementing its product offerings

by acquiring small independent manufacturers or the kitchen appliance product lines of large diversified manufacturers.

The company carefully followed changes in customer purchasing behavior and market trends. Victor Dubinski and the board were eager to continue what they believed had been a fruitful strategy. The company was particularly keen to increase its presence in the beverage appliance segment, which demonstrated the strongest growth and where BKI was weakest. Thus far, all acquisitions had been for cash or BKI stock.

Financial Performance

During the year ended December 31, 2006, Blaine earned a net income of \$53.6 million on revenue of \$342 million.

Exhibits 1 and 2 present the company's recent financial statements. Approximately 85% of Blaine's revenue and 80% of its operating income came from the sale of mid-tier products, with the line of higher-end goods accounting for the remainder. The company's 2006 EBITDA margin of nearly 22% was among the strongest within the peer group shown in Exhibit 3. Despite its recent shift toward higher-end product lines, Blaine's operating margins had decreased slightly over the last three years. Margins declined due to integration costs and inventory write-downs associated with recent acquisitions.

Now that integration activities were completed, BKI executives expected the firm to achieve operating margins at least as high as its historical margins. The U. S. industry as a whole faced considerable pressure from imports and private label products, as well as a shift in consumer purchasing preferences favoring larger, "big box" retailers. In response, some of Blaine's more

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aggressive rivals were cutting prices to maintain sales growth. Blaine had not followed suit and its organic revenue growth had suffered in recent years, as some of its core products lost market share.

Growth in Blaine's top line was attributable almost exclusively to acquisitions. Despite the company's profitability, returns to shareholders had been somewhat below average. Blaine's return on equity (ROE), shown below, was significantly below that of its publicly traded peers. 1 Moreover, its earnings per share had fallen significantly since 2004, partly due to dilutive acquisitions.

Companies	2006 ROE
Home & Hearth Design	11.3%
AutoTech Appliances	43.1%
XQL Corp.	19.5%
Bunkerhill Incorporated	41.7%
EasyLiving Systems	13.9%
Mean	25.9%

Median	19.5%
Blaine	11.0%

¹ ROE is computed here as net income divided by end-of-period book equity.

During 2004–2006, compounded annual returns for BKI shareholders, including dividends and stock price appreciation, were approximately 11% per year.

This was higher than the S&P 500, which returned approximately 10% per year. However, it was well below the 16% annual compounded return earned by shareholders of Blaine's peer group during the same period. Financial Policies Blaine's financial posture was conservative and very much in keeping with BKI's long-standing practice and, indeed, with its management style generally. Only twice in its history had the company borrowed beyond seasonal working capital needs. The first time was during World War II when it borrowed from the U. S. government to retool several factories for war production.

The second time was during the first oil shock of the 1970s. On both occasions, the debt was repaid as quickly as possible. At the end of 2006, Blaine's balance sheet was the strongest in the industry. Not only was it debt-free, but the company also held \$231 million in cash and securities at the end of 2006, down from \$286 million two years earlier. Given such substantial liquidity, Blaine had terminated in 2002 a revolving credit agreement designed to provide standby credit for seasonal needs; the CFO argued that the fees were a waste of money and Dubinski agreed.

In recent years the company's largest uses of cash had been common dividends and cash consideration paid in various acquisitions. Dividends per share had risen only modestly during 2004–2006; however, as the company issued new shares in connection with some of its acquisitions, the number of shares outstanding climbed, and the payout ratio rose significantly, to more than 50% in 2006.

-	2004	2005	2006
Net income	\$ 53, 112	\$ 52, 435	\$ 53, 630
Dividends	\$ 18, 589	\$ 22, 871	\$ 28, 345
Average shares outstanding	41, 309	48, 970	59, 052
Earnings per share	\$ 1. 29	\$ 1. 07	\$ 0. 91
Dividend per share	\$ 0. 45	\$ 0. 47	\$ 0. 48
Payout ratio	35. 0%	43. 6%	52. 9%

The next largest use of funds was capital expenditures, which were modest due to Blaine's extensive outsourcing of its manufacturing. Average capital expenditures during the past three years were just over \$10 million per year. While they were expected to remain modest, future expenditures would be

driven in part by the extent and nature of Blaine's future acquisitions. In recent years, after-tax cash generated from operations had been more than four times average capital expenditures and rising, as shown in the table below. 4

EBITDA Less: Taxes After-Tax Operating Cash Flow

2004 69, 370 24, 989 44, 380

2005 \$ 68, 895 24, 303 44, 592

2006 \$ 73, 860 23, 821 50, 039

AVG. 46, 337

However, this growth rate assumed no acquisitions would be made in 2007, unlike the previous two years. While the board remained receptive to opportunities, Dubinski and his team had no target in mind as yet at the end of April. As he reflected on the possibility of repurchasing stock, Dubinski understood that he could consider such a move only in conjunction with all of BKI's financial policies: its liquidity, capital structure, dividend policy, ownership structure, and acquisition plans. In addition, he wondered about timing. Blaine's stock price was not far off its all-time high, yet its performance clearly lagged that of its peers.

A summary of contemporaneous financial market information is provided in Exhibit 4. Dubinski had begun to suspect that family members on the board would welcome some of the possible effects of a large share repurchase. Assuming that family members held on to their shares, their percentage ownership of Blaine would rise, reversing a downward trend dating from BKI's IPO. It also would give the board more flexibility in setting future

dividends per share. Both Dubinski and the board knew that the recent trend in BKI's payout ratio was unsustainable and that this concerned some family members.

On the other hand, a large repurchase might be unpopular if it forced Blaine to give up its war chest and/or discontinue its acquisition activity. Perhaps even more unsettling, it would cause Blaine to borrow money. The company would be paying significant interest expense for only the third time in its history. As Dubinski turned his chair to face the window, he glanced at the framed photo behind his desk of his great grandfather, Marcus Blaine, demonstrating the company's first cream separator—its best-selling product during Blaine's first decade.

A real Blaine Electrical Cream Separator sat in a glass case in the corner; the last one had been manufactured in 1949.

Blaine Kitchenware, Inc., Income Statements, years ended December 31, (\$ in Thousands)

Operating Results	2004	2005	2006	2007	2008	2009	2010	2011	2012
Net Income	\$291,940	\$204,265	\$101,249	\$98,914	\$76,738	\$24,303	\$77,451	\$23,821	\$52,435
Dividends	63,946	9,914	68,895	73,860	60,682	16,057	63,946	3,506	78,101
Earnings Before Tax	345,500	11,100	18,589	60,682	8,213	53,112	18,589	5,500	11,100
Less: Taxes	54,560	1,186	10,692	7,822	2,148	19,255	7,822	1,594	1,875
EBIT	291,940	9,914	7,897	52,860	6,065	33,857	10,767	3,906	9,225
Plus: Other Income (expense)	92,458	28,512	62,383	15,719	6,987	3,506	78,101	24,989	76,738
EBITDA	384,398	38,426	69,280	68,579	13,052	37,363	86,808	28,495	85,963
Operating Income	291,940	204,265	101,249	98,914	76,738	24,303	77,451	23,821	52,435
Plus: Depreciation & Amortization	342,251	249,794	62,383	6,987	307,964	220,234	87,676	25,293	25,293
Gross Profit	342,251	249,794	62,383	6,987	307,964	220,234	87,676	25,293	25,293
Less: Selling, General & Administrative	307,964	220,234	87,676	25,293	25,293	25,293	25,293	25,293	25,293
Revenue	307,964	220,234	87,676	25,293	25,293	25,293	25,293	25,293	25,293
Less: Cost of Goods Sold	65,714	70,440	25,293	18,306	18,306	18,306	18,306	18,306	18,306
Margins	3.2%	30.0%	28.5%	27.0%	21.4%	19.7%	18.7%	23.8%	22.4%
Revenue Growth	3.2%	30.0%	28.5%	27.0%	21.4%	19.7%	18.7%	23.8%	22.4%

8% Net Income Margin 18. 2% 17. 0% 15. 7% Dividend payout ratio 5. 0%
43. 6% 52. 9% EBIT Margin EBITDA Margin Blaine's future tax rate was
expected to rise to the statutory rate of 40%.

Effective Tax Rate

Exhibit 2

Blaine Kitchenware, Inc. Balance Sheets, December 31, (\$ in Thousands)

Assets	2004	2005	2006
Cash & Cash Equivalents	\$ 67, 391		
Goodwill			
Other Assets			
Total Assets	48, 780	49, 728	54, 874
Property, Plant & Equipment	3, 871	5, 157	376, 351
Total Current Assets	43, 235	2, 586	
Other Current Assets	164, 309	47, 262	
Inventory	\$ 66, 557	196, 763	40, 709
Accounts Receivable	\$ 70, 853	218, 403	
Marketable Securities	364, 449	339, 678	99, 402
	138, 546	174, 321	8, 134
	20, 439	38, 281	13, 331
	27, 394	39, 973	\$497, 217
	\$550, 829	\$592, 253	\$ 26, 106
	\$ 28, 589	\$ 31, 936	22, 605
	24, 921	27, 761	14, 225
	17, 196	16, 884	62, 935
	70, 705	76, 581	1, 794
	3, 151	4, 814	15, 111
	18, 434	22, 495	79, 840
	92, 290	103, 890	
Liabilities & Shareholders' Equity			
Accounts Payable			
Accrued Liabilities			
Taxes Payable			
Total Current Liabilities			
Other liabilities			

Deferred Taxes Total Liabilities Shareholders' Equity Total Liabilities & Shareholders' Equity 458, 538 488, 363 \$550, 829 \$592, 253 Many items in BKI's historical balance sheets (e. g. , Property, Plant & Equipment) have been affected by the firm's acquisitions.

Note: 417, 377 \$497, 217 45. 18% 31. 12% Net Debt/Equity Net Debt/Enterprise Value

Net debt is a total long-term and short-term debt less excess cash.

Net working capital excludes cash and securities. 1. 91x 10. 56x 9. 46x 1. 63x 1. 03 776, 427 \$1, 127, 226 \$ 350, 798 372, 293 475, 377 LTM Trading Multiples MVIC/Revenue MVIC/EBIT MVIC/EBITDA Market/Book equity Equity beta Market capitalization Enterprise value (MVIC) Net debtb Total debt Book equity \$ 21, 495 54, 316 900, 803 \$ 976, 613 31. 74% 24. 10% 1. 02x 7. 35x 6. 03x 4. 26x 1. 24 17. 97% 15. 23% 1. 5x 8. 65x 7. 84x 2. 51x 0. 96 5, 290, 145 \$6, 240, 947 \$ 950, 802 972, 227 2, 109, 400 \$ 21, 425 353, 691 3, 322, 837 \$3, 697, 952 \$4, 313, 300 721, 297 796, 497 \$ 412, 307 XQL Corp. -15. 47% -18. 31% 1. 87x 18. 05x 15. 15x 4. 41x 0. 67 418, 749 \$ 353, 949 \$ (64, 800) 177, 302 94, 919 \$ 242, 102 21, 220 68, 788 \$ 332, 110 \$ 188, 955 19, 613 23, 356 \$ 13, 173 EasyLiving Systems 4040 -8- -24. 06% -31. 68% 2. 13x 11. 40x 9. 87x 1. 96x 0. 56 959, 596 \$ 728, 730 \$(230, 866) 488, 363 \$ 230, 866 32, 231 174, 321 \$ 592, 253 \$ 342, 251 63, 946 73, 860 \$ 53, 630 Blaine Kitchenware 6. 01% 5. 67% 1. 14x 7. 42x 6. 88x 4. 93x 0. 92 3, 962, 780 \$4, 200, 836 \$ 238, 056 391, 736 04, 400 \$ 153, 680 334, 804 815, 304 \$1, 303, 788 \$3, 671, 100 566, 099 610, 399 \$ 335, 073 Bunkerhill, Inc. 13, 978, 375 \$18, 415, 689 \$4, 437, 314 4, 973, 413 3, 283, 000 \$ 536, 099 1, 247, 520 7, 463, 564 \$9, 247, 183 \$18, 080, 000 2, 505, 200 3, 055, 200 \$1, 416, 012 AutoTech Appliances No \$ 589, 747 106, 763 119, 190 \$ 53, 698 Home & Hearth Design Selected Operating and Financial Data for Public Kitchenware Producers, 12 months ended December 31, 2006, (\$ in Thousands) Cash & securities Net working capitala Net fixed assets Total assets Revenue EBIT EBITDA Net income

Exhibit 3 Exhibit 4

Contemporaneous Capital Market Data (April 21, 2007) Yields on U. S. Treasury Securities Maturity

30 days 60 days 90 days 1 year 5 years 10 years 20 years 30 years

4.55% 4.73% 4.91% 4.90% 4.91% 5.02% 5.26% 5.10%

Default spread 0.86% 1.02% 1.33% 1.70% 2.86% 3.92%

Seasoned corporate bond yields Moody's

Aaa 5.88% Aa 6.04% A 6.35% Baa 6.72% Ba 7.88% B 8.94%