

Sterling Household Products Company

Capital Market reactions to increase use of debt

- Initial shareholder uncertainty
- Affects following repurchase
- Short term vs long term
- Ambiguous affect on capital markets/share price



Business Risks

- Leveraged firm is more volatile
- Volatility and volatility specific risk
- Tax shield risk - changes and uncertainty
- Equilibrium risk - future debt capacity
- Debt maturity
- Diversified range of products
- Market approach to NPV



Before choosing to repurchase capital structure, ask yourself whether:

1. You can pay
2. Company is profitable
3. You have cash
4. Cash is not too tight
5. You have a good idea of the future
6. You have a good idea of the future
7. You have a good idea of the future
8. You have a good idea of the future



Leveraging up American Home Products

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Capital structure policy

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Background of AHP

- Founded 1926 when Sterling Products and Household Products merged
- Now known as Wyeth Corporation
- Products include Black Flag, Woolite, Chef Boyardee, Easy-Off and Anacin.



Wyeth



Bankruptcy costs

Direct costs - fees and payments to the court
Indirect costs - financial costs
Bankruptcy affects the company



Recommendation

Should use 50% debt because...

- The firm is profitable and has a good idea of the future
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Potential value from proposed levels of debt

30%	\$25.7m
50%	\$42.12m
70%	\$58.97m

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Business Risks

- Leveraged firm is more volatile
- Leverage and volatility go to risk
- Financial distress, changes and liquidation
- Equilibrium risk - sub-optimal product mix
- Shareholder agency
- Distorted range of products
- New debt approach in 1992



Before choosing to repurchase capital structure, ask yourself whether:

1. You can pay
2. Company is strong
3. You have it
4. Value of equity is high
5. Financially sound
6. Agency costs
7. Shareholder benefits
8. Not too late



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Capital structure policy



1997 capital structure policy



Capital structure policy



Bankruptcy costs

- Direct costs - fees and payments to the court
- Indirect costs - financial costs that negatively affect the company



Recommendation

- Should use 50% debt because:
- 1. Financially sound
- 2. Value of equity is high
- 3. Financially sound
- 4. Agency costs
- 5. Shareholder benefits
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1,500 consumer goods allocated
among four distinct lines of business

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- Prescription drugs
- Packaged drugs
- Food products
- Houseware and household products



Debt Policy and Capital
Structure

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- Low debt levels, high cash on balance sheet
- CEO, William F. Laporte had a conservative managerial approach
- Laporte's brand of centralized micro-management created a firm with a AAA bond rating

"we run this company for the shareholders"

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Advantages

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- Tax Shield
 - Hypothetical = $14\% \times 30\% = 4.2\%$, $14\% - 4.2\% = 9.8\%$
 - Actual = $14\% \times 48\% = 6.72\%$, $14\% - 6.72\% = 7.28\%$
- Discipline to management
- Pecking order theory
- Higher EPS and ROE
- Increased room for growth

Disadvantages

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- Bankruptcy costs
- Increased risk (beta)
- Agency costs
- Loss of future financial flexibility
- Interest foregone on excess cash/ Opportunity cost of holding cash.



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