

A pre-downturn comparison on capital
structure strategy, from the perspective
of a Swedish retailer

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Abstract

Capital structure decisions and impacts have always been on top of every CFO's and shareholder's mind. Many theories have been presented and so far, no apparent consensus regarding how, why or when financing should be done in order to maximize firm value, exists.

This thesis relates the most prominent theories to *KIN Group*, one of Swedens major retailers with the aim to uncover the underlying factors for its financing decisions. The study gathers data from 2007 in order to capture the complexity of managing, not only a rapid-growing private company, but also while combatting challenges of the recent financial downturn in 2008.

Semi-structured interviews are conducted with the CFO and the company's two shareholders and a significant quantity of raw financial data is analyzed. The findings suggest that the most applicable forms of framework in the KIN Group case are the *market timing* theory due to information asymmetry and hence, the willingness to finance ownership based on market trends. As a private company, this becomes a little bit more difficult since pricing of shares becomes a complex process. In this context, shareholder and investor perception of future cash flows differed, and hence the given offer was considered underpriced. Second, the firm demonstrated the *principle of least effort* approach, which is a pragmatic framework for financing decisions. This had great impact on KIN Group's pursuit for capital, and as the debt-levels already was burdened, equity was the only feasible choice. Third, the findings show that no other of the academic theories covered in this thesis is applied within KIN Group in their obtaining of capital structure.

Finally, the findings covered in this thesis suggest that the firm value creation was to a high degree dependent on the leverage undertaken by KIN Group. By implementing WACC calculations, we can conclude that the firm value had increased to an approximate level of MSEK 686.5 by the end of 2010. By conducting a *what-if* analysis, assuming no leverage and 15% annual growth, the firm value would instead have reached a level of approximate MSEK 167.

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Chapter 1

Introduction

Research within the field of corporate finance has been extensive in recent years. Many theories have been introduced to approach the different issues facing the firms of today. One of the more heavily discussed issues is the firms' challenge to obtain the optimal balance between debt and equity, often referred to as the capital structure of a firm. The importance of this topic derives from the fact that capital structure is highly related to the firms' ability to achieve the goals of the various stakeholders.

Research tells us that capital structure have impact on highly significant factors such as the firms market value, governance and even performance. The foundation was set by Modigliani and Miller (1958), inferring the capital structures non-impact on firm value. Their article commenced the debate and was contradicted by various authors, e.g., Lubatkin and Chatterjee (1994), who stated that a relationship between capital structure and a firm's *weighted average cost of capital* (WACC) actually exists. Thus, a well thought out strategy in order to maximize shareholder value should be in every CFO's interest. However, Florackis (2008) discovered that the capital structure also have significant impact on agency costs, making it not only a subject for managers but also for shareholders. Given this information, how can managers and shareholders *maximize profit* based on a sound debt-to-equity ratio (D/E)? Furthermore, how can managers and shareholders maintain a sound debt-to-equity under extreme macroeconomic conditions, such as the recent financial downturn?

This study will take a deeper look in the reality of capital structure decisions. A qualitative study on *KIN Group*, one of Sweden's major retailers will give us a closer understanding in how managers and shareholders address this issue and what the sustained impacts are. Furthermore, the aim of this study is to mediate a clear picture of how a specific company is run, in contrast to the large amount of quantitative studies conducted already. We believe a case study based thesis will contribute, perhaps not to the academic theory, but rather to actual businesses practices. Hence, the purpose for this thesis is to make a pre-downturn comparison on capital structure. This thesis should be of great interest for some of today's working professionals, managers and shareholders since so far, firms have very limited sources of information containing qualitative data on this topic.

Even though many of the studies already conducted have used a quantitative approach, and contained regression and statistic analysis, it could be beneficial to further study the underlying factors for financing decisions, which could be much more complex. For this reason, it is of interest to make a qualitative study. In addition to this, a qualitative approach is better suited for a case study of this scope.

1.1 Background

The problem with academic research on capital structure is the relative simplicity in finding empirical support for almost any theory. As Frank and Goyal (2009) emphasized; how can we distinguish if a theory is, not only good or bad, but also applicable in a specific context? The former president of the American Finance Association, Stewart Myers (1983), were clearly skeptic to his own findings and admitted that not even his plausible and well renowned trade-off theory nor pecking order theory were accurate enough to recommend to managers. The theorem presented by Modigliani and Miller (1963) is, though simple, still considered as one of the fundamental basics of capital structure. The idea to increase profit by levering operations is however opposed by Simerly and Li (2000) when dealing on dynamic markets, since not only positive results are magnified, but potential losses as well. No one should believe that a model can capture the complexity of big corporations. So far, no single theory has been versatile enough in order to be relied upon in any given business case, and especially not during a financial crisis.

As theories that try to explain financing behavior often fail to deliver any truth, some studies are more successful in explaining consequences related to financing strategies. Simerly and Li (2000) presents findings that suggest that debt have a negative impact on competitiveness as the impositions of covenants limits the firms ability to make strategic choices. Second, they argue as debt increases, the corporate governance can change from internal to external control, which can have significant impact on the firms' ability to act on a competitive environment as well as managerial discretion. However, there are always two sides of a coin. Jensen's (1986) findings suggest that the debt-to-equity ratio is a powerful tool when managing agency costs. According to Jensen, debt have a controlling effect on managers since they commit to pay out future cash flows, which otherwise would have been used to invest in low-return projects. So, in reality, how much attention do firms pay to capital structure? A survey based on over 4.000 firms and 300 CFO's, conducted by Graham and Harvey (2001), mentions that 55% of large companies have strict target debt-to-equity ratios (as compared to the average of 44%). The most important factor related to debt ratios is financial flexibility, i.e. to have enough internal funds to pursue new projects as they come along. Further, their survey suggest, in contrary to Jensen (1986), that the least important factor among firms is to that ensure upper management to work efficiently by using debt as a motivator.

A more pragmatic approach to capital structure was presented by the McKin-

sey consultants Goedhart et al. (2006) who stated that companies should not fall into the trap trying to maximize tax shields. Instead they should focus on attaining a debt-balance which suits their specific business strategy. According to their research, the most important trade-off regarding debt is the one between financial flexibility and fiscal discipline. With this in mind, a firm should predict future revenues and investment requirements, and thereafter change the capital structure in accordance. Their research further suggests that it can be of great benefit to carry less debt than your competitors, since you will be less burdened by covenants and thus more able to make contra-cyclical investments, which overtime will generate more profit.

With this brief background in mind, it can be concluded that no real consensus exists on this topic, which enhances the relevance of this research. In order to achieve the goal of this thesis, we need to form a solid foundation for the forthcoming analysis. The next chapter will describe the fundamental theories that will be applied in the research. First of all we describe the financial mathematics, which can be used to calculate WACC and company valuation. This knowledge will be useful for further understanding of capital structure decisions and the impact it has on these key figures. Second, we will review some of the fundamental theories regarding capital structure, such as the market timing-, trade-off-, and pecking order framework.

Chapter 2

Theory

2.1 Theoretical review

As already mentioned, this issue was first recognized by Modigliani and Miller (1958), in their study which have been praised and condemned both, but is nonetheless still considered fundamental in this field. They defined the irrelevance of capital structure (1958), under the condition that no corporate taxes or costs of financial distress exist and investors and corporations borrow at the same rates. In this case, the required return on equity (R_e) will be compensated by the required return on debt (R_d). This left Modigliani and Miller (1963) with

$$R_e = R_0 + \frac{D}{E}(R_0 - R_d)$$

Where R_0 represents the unlevered firms assumed cost of capital. This expression let us obtain the indifference between the value of a levered (V_L) or unlevered (V_U) firm:

$$V_L = V_U$$

For this reason, the firm value is invariant to different debt-to-equity ratios (D/E), given that the already stated preconditions are met, which in reality is highly unlikely.

In reality, a more probable environment is to incorporate the burden, or advantage, of taxes. As Lubatkin and Chatterjee (1994) mentioned, debt financing is tax deductible and thereby allows companies to pass a portion of the cost of capital from their shareholders to the government. In this way, firms can increase the shareholder value by financing their operations with debt rather than equity. This is also how Modigliani and Miller (1963) made their model a little bit more applicable with the imposition of corporate tax (T_c). The substitution of debt financing for equity reduces the amount of tax a firm must pay which increases the after-tax cash flow generated by the firm's assets, and in turn increases the firm value. This is explained by the interest tax shield:

$$T_c \cdot R_d \cdot D$$

And the present value of the tax shield (PV_t):

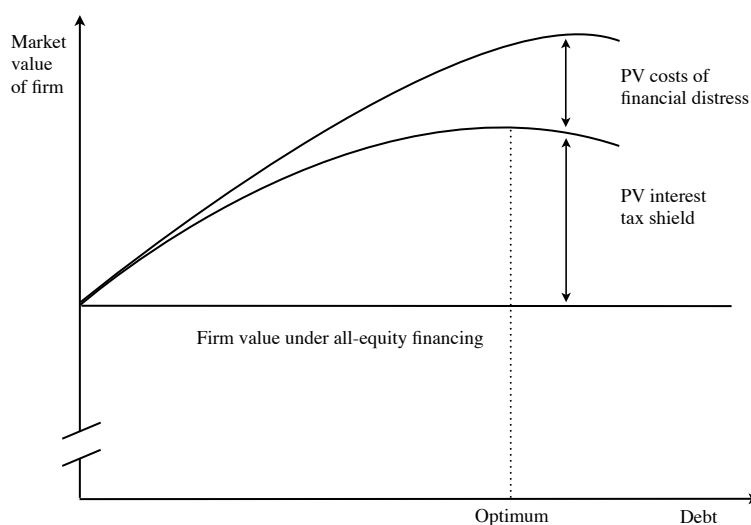
$$PV_t = \frac{T_c \cdot R_d \cdot D}{R_d}$$

This means that the value of a levered firm is equal to the value of an unlevered firm *plus* the present value of interest tax shields that debt financing is expected to generate in the future.

$$V_L = V_U + PV_t = V_U + T_c \cdot D$$

Hence, the higher the debt - the larger present value of the interest tax shield, i.e. lower cost of capital. This, of course, is only profitable until the marginal benefit of the tax shield measure the marginal cost of debt, as described by Stewart Myers (1984). Myers called it the *trade-off hypothesis*, which, in theory, is a useful framework in order to identify the optimal debt level. However, the hypothesis is a static trade-off model which doesn't take cost of adjusting debt into account, since no firm can immediately offset random events which bump them away from the optimum. Therefore, there is a lag between the trade-off hypotheses as it applies to reality.

Figure 2.1: Trade-off between the interest tax shield and financial distress



Model presented by Myers (1984)

In addition to the trade-off hypothesis, Myers (1984) also reintroduced the *pecking order* framework, originally presented by Donaldson's study (1961), which basically is founded on the idea that firms prefer internal financing to debt and equity, often known as the *principle of least effort*. This model is risk averse, since committing to internal funds is less risky than external. If external capital is required firms issue the safest security first, which is debt. Then, according to

Myers, firms consider hybrid securities such as convertible bonds, and as a last resort they turn to equity. Naturally, there are plenty of cases of firms issuing stock when they could issue debt - but when aggregated - the heavy reliance on internal capital over debt is clear.

In corporate finance, there is an evident relationship between a firm's cost of capital and the value of the firm. The lower the WACC - the greater the productivity and hence higher firm value of the firm. Therefore, it is relevant to determine the firm's WACC, which is easily done by calculating the cost of each source of financing, debt and equity:

$$WACC = R_e^L \cdot \frac{E}{E + D} + R_d \cdot (1 - T_c) \cdot \frac{D}{E + D}$$

Thereafter, it is possible to find out the firm's (approximate) value (V) by,

$$V = \frac{EBIT \cdot (1 - T_c)}{WACC}$$

This model has, however, received criticism due to the possibility to apply other capital structures than the actual, e.g., industry standard or contemplated structure, and therefore facilitate biased valuations. In addition, the fact that this model excludes costs of financial distress makes it even less accurate. For a more market-oriented valuation that also accounts for the systematic risk, the capital asset pricing model (CAPM) is a suitable approach. The CAPM is essential for assuming the firm's internal required return on equity, and hence relevant for the WACC determination. The way the founders, and among them William Sharpe (1964), describe the model, the required return on equity (R_e^L) is determined by:

$$R_e^L = R_f + \beta \cdot (R_m - R_f)$$

Where R_f equals the risk-free rate, the beta value (β_i) represents the systematic risk and R_m corresponds to the expected return on the specific market. This method can give stakeholders a good financial insight with very little effort. In this context, the WACC model is of interest since capital structure is a variable which determines the firm value, as opposed to any other model.

In addition to this, by analyzing the *degree of financial leverage* model (DFL), we can observe increasing volatility of cash flows as debt-ratios increases, i.e., more debt - higher risk. For this reason, creditors' interest in the firm increases in accordance to the debt level,

$$DFL = \frac{EBIT}{EBIT - Interest}$$

In contrast to these static models, we should also highlight the common managerial method to time market fluctuations, referred to as *market timing*. The most general market timing method implies that due to informational asymmetry, firms issue or repurchase stock if they consider it undervalued, and if

overvalued, issue equity. Other traditional forms of market timing have also been recognized such as debt issuance when interest rates are low, or short-term issuing if improved credit ratings are expected. As shown by Graham and Harvey (2001), however, the ratings have very little impact on short-term issuance among companies.

The firm's ability to, by operational cash flow, properly pay amortizations and interest is measured by the *debt service capacity*. This is highly relevant in the context of financing investments by debt, since it, ideally, gives management and shareholders a plausible insight on how to maintain a stable capital structure. In general, the debt service capacity is calculated by,

$$EBITDA \pm WC \pm CAPEX \pm Tax$$

Which, in addition to any head-room calculated for, must cover all expensed related to the debt and hence constitutes the limit of debt undertaken by a firm.

2.2 Criticism

As we have reviewed the most prominent theories within capital structure studies, some awareness regarding their accuracy should be provided. The models presented by Modigliani and Miller, etc., are founded on the condition of perfect markets and are significantly simplified in relation to real-life business valuation. The *value* must not be interpreted as *market value* since other factors, e.g., market predictions, goodwill, etc, also have impact in the final valuation. Further, none of the above mentioned theories must be interpreted as a correct reflection of the reality, but rather as very simplistic description of various events.

Table 2.1: Summary of theoretic frameworks

Theory:	Measurement:
Tax shield valuation	After tax returns
Trade-off theorem	Optimal debt level
WACC model	Firm valuation
Market timing theorem	Financing incentives
Debt service capacity	Undertaken debt limit

With this chapter in mind, we have formed a solid foundation on capital structure theory and are ready to progress with the empirical study. Prior, however, we need to conceptualize the research design, from theoretical models to a consistent and efficient methodological framework. The next chapter will guide us through the issues and opportunities facing this study and present the analytical approach as well as the underlying motivations.

Chapter 3

Research design

3.1 Methodology

Let us first review the scope of this study. The aim is to relate the academic theory to a prominent enterprise and present an accurate overview of how well, or badly, current theories apply to actual business practices. Moreover, a pre-crisis comparison on capital structure strategy will be conducted. What factors in the financial environment have changed and how did the company adapt to this change?

In order to achieve this, a central part is the selection of research object, which will be essential during the course of the research phase and hence, for the outcome of this thesis. During the recent crisis no industry remained unharmed, but some were more affected than others. The study conducted by Howell et al. (2010) implies that the retail industry experienced the most rapid loss, after financial services, due to the fact that consumers' perception of future disposable income dropped tremendously, and as result reduced the level of consumption. Hence, an actor within retailing should be of interest whilst conducting further studies in the matter. In addition to this, a private retailer would shed light on issues rarely addressed by researchers in this field. With this perspective in mind KIN Group, as a growing firm, stands out as a suitable choice.

The research will be conducted as a single case study based on financial information and interviews with the two shareholders and the Chief Financial Officer. No other key individual have the relevant insight in capital structure decisions, and hence narrow the amount of interviews required. In order to gain depth rather than breadth, semi-structured interviews are appropriate since they allow the respondents to commit to a specified topic whilst they remain able to elaborate their thoughts and perspectives. For the outcome of this thesis, this is a significant advantage compared to any other approach. Moreover, the gathered data is processed by triangulation and thus increase the level of validity. The interviews are structured into three parts: before-, during- and after the financial crisis. During each part, the following questions were discussed:

- *How did the internal process to obtain the optimal capital structure (at the specific time) advance?*
- *Which were the underlying factors for the applied decision?*
- *Based on the applied financing solution, what were the outcome and challenges related to the outcome? How were these addressed?*

The composition of these questions should be satisfying in terms of theoretic coverage. The first two questions aimed to enable the interview object to relate to the trade-off-, tax shield- or market timing theories. The third question is suitable for evaluating decision impacts, and hence draws conclusions from a managerial point of view. In addition to this, first-hand financial data was gathered and analyzed with the intent to empirically relate given answers to actual outcome.

This methodology should suffice to present accurate and credible findings regarding financial management under extreme financial conditions. However, some critical awareness regarding data gathering should be undertaken since this study only conducts interviews with three individuals. The firm studied in this thesis has, in contrast to traditional corporate governance, shareholders who are highly involved in day-to-day operations. For this reason, common issues, such as agency costs, may in this case not be representative for the average mid-size company. Other factors related to the small amount of interview objects could consist of the dependent criterion, i.e., that responses derive from the same sources of information. Further, the threat that the firm's own agenda bias the findings is, of course, imminent.

In addition, awareness regarding the scientific outcome of this thesis should be addressed. As this study focus on one actor alone, the findings will not present any definite conclusions on the issue on capital structure in general, but rather illustrate the actual events that occurred in this particular case. This means that the conclusions drawn from this study must be acknowledged, not for its contribution to academic research, but for the link to actual business practices. However, this should not undermine the importance of this study. Ultimately, it is up to the reader to *reflect on the conclusions* gained from this thesis and choose whether or not to apply it in his or hers professional or academic life.

The next chapter will present the obtained empirical results. No credit institutions or investment funds in this thesis have been referred to by name due to discretionary reasons. However, details regarding dates, values and rates have been presented in the most accurate manner possible. The initial part cover the corporate background and then progress with the various events that occurred prior, during and after the financial downturn.

Chapter 4

Empirical results

4.1 A Swedish retailer

This thesis illustrates the challenges of capital structure decisions. In order to capture the complexity of big corporations a study has been made on *KIN Group*, an unlisted Swedish company within the retail industry. Ten years ago, the company, as here on will be referred to as the *Group*, consisted of a wholesale department - *Klockgrossisten i Norden* - based out of Stockholm, Sweden. Since then, the Group have experienced growth, both organic and by acquisitions and consists today of four subsidiaries, which operates in Sweden and abroad. The Group has a total of over 275 stores, employs over 1.000 people and had a turnover of over SEK 2 billion last year (2009).

The first major acquisition took place in Sweden 2002, increasing the numbers of stores by 40, through the realization of the take over of *Ur & Penn*. A few years later, another two retailers of approximately 100 stores each were acquired. In the mean time, some 30 new stores opened and a few closed. The rapid growth-rate was to a large extent made possible by debt financing. So far, 100% of the acquisitions was financed by debt, and thus made the Group highly levered.

The recent financial downturn on the financial markets had tremendous impact on the Group's financing situation. As creditors feared a global financial meltdown, they took all precautions possible. Honoring the strictly monitored covenants, which in relation to the decreasing sales, were very difficult. Focus from senior managers changed from commercial orientation to satisfying external parties, which in turn enhanced the negative figures.

4.2 Expansion

Five years ago, there was great confidence that the Group's domestic competitive advantage; unmatched business know-how and unique retail concept, were transferable to foreign markets. The firm managed a successful debt repayment, as a result of strong cash flows and the overall financing situation was considered very sound. The unlevered cash flows from existing operations facilitated the international expansion into new territories. In 2006, *Lucardi*, a Dutch jeweler

chain, was the first foreign retailer to be acquired. The company had experienced tough years with low margins and no substantial profits. Soon after the take over, the new management, assortment and in-store marketing all contributed to higher return and the short turnaround time of nine months. The creditor, one of Sweden's major commercial banks, funded the whole acquisition which was soon fully repaid due to the positive turnaround. The positive outcome of this project stimulated forth going growth and the screening of a second foreign retailer was initiated. The economic incentive to acquire a bleeding actor to a good price and make it profitable was very high, as was the confidence of the own ability. The next target, *Kijkshop*, another Dutch retailer, was found in the end of 2006. Kijkshop was a local market leader in terms of store quantity but suffered from unsuccessful positioning and negative cash flows.

Since the Group had not yet generated sufficient internal funds to finance investments of this magnitude, both equity and debt financing were considered. The main complication when financing this investment was equity pricing. As a private company, the valuation of equity constituted a major challenge as shareholders' and prospective investors' perception of future value differed. After negotiations with a vast number of private- and institutional investors, debt issuance remained the most attractive option.

As the strategy how to best transform this bleeding retailer into a successful turnaround case was presented to the Group's current bank, the Group simultaneously pitched another major bank. The management considered it risky to depend on only one creditor, and increased the bargaining power by letting another institution into the negotiations. When the final stage of negotiations ended, the current bank refused a long-term loan to cover 100% of the acquisition. Fortunately, the new bank was able and willing to provide the required funding and, hence, the Group switched bank. In general, credit institutions had few limitations in providing funding. Within retail, creditors often granted long-term loans 5 to 7 times EBITDA (as compared to today's multiple of 2 to 3). The debt-to-equity ratio was reaching the peak of 3.3 in November 2007 (all figures are presented in MSEK).

Table 4.1: Financial data relevant for WACC determination

KPI	2010	2009	2008	2007
Debt to Equity	0.8	1.2	2.6	3.3
Net debt	169	207	324	346
Equity	209	167	126	106
Interest rate [%]	6.9	8.2	8.3	5.5
Required return on equity [%]	15.5	15.5	15.5	15.5
EBIT	101	59.5	29.2	20.9

The required rate of return on equity is calculated by the CAPM. All values below corresponds to the Groups actual CAPM calculations.

$$R_e^L = R_f + \beta \cdot (R_m - R_f)$$

$$R_e^L = 5.5\% + 1 \cdot (15.5\% - 5.5\%) = 15.5\%$$

This concludes that the internal return on equity measures 15.5%. As this factor is known, the 2007 WACC can be determined by:

$$WACC = R_e^L \cdot \frac{E}{E + D} + R_d \cdot (1 - T_c) \cdot \frac{D}{E + D} =$$

$$15.5\% \cdot \frac{106}{106 + 346} + 5.5\% \cdot (1 - 26.3\%) \cdot \frac{346}{106 + 346} = 6.74\%$$

Noteworthy is the high level of debt compared to equity. The D/E ratio measures 3.3 which is a result of the significant levels of investments. Naturally, this impacts the cost of capital which in this case is mostly driven by the cost of debt. Fortunately, the cost of debt at this stage is generally low, which results in a fairly moderate WACC, which generates a firm value of:

$$V = \frac{EBIT \cdot (1 - T_c)}{WACC} =$$

$$\frac{20.9 \cdot (1 - 26.3\%)}{6.74\%} = 228$$

The firm value is, as the formula illustrates, driven by the current level of EBIT. As a result of this, changes in sales and thus, earnings, will impact the firm value, which makes the perception of future earnings an important factor when considering a fair valuation.

4.3 Recession impacts

Soon after the second investment, in the year of 2008, recession hits the global economy. Financial institutions world-wide struggle to maintain a clean balance sheet and the pricing of equity rises dramatically as banks, corporations and even nations collapse. The increasing unemployment rates impact on the consumerism negatively which, of course, affects the entire retail industry.

This has sincere effects on the Group's ownership situation. As sales did not meet expectations, problems to satisfy agreed upon covenants started to occur, both in terms of debt service capacity and interest coverage ratio. The bank-agreement, with a progressive amortization rate, the situation was no longer sustainable and the management had to solve the shortage of funding. To postpone one or two amortizations would give the firm a well needed head room and time to focus on its core business. In the mean time, the *working capital revolver*, which is a part the debt, especially designated to finance seasonal fluctuations, was used to facilitate the ownership financing. However, these actions as well as the postponing of amortizations proposed to the creditors, were directly neglected and gave a reaction in the opposite direction. If no equity was issued, the bank would take control over the firm. Hence, in order to maintain operational control, the Group was pressured to conduct a forced sale. Naturally, the equity pricing is lower at this stage than a year ago (when it also was considered underpriced) due to the unstable financing situation and recent declined revenues.

For this reason, the Group had no choice but to, in one way or another, decrease the D/E ratio by increasing the amount of equity. In mid 2008, the challenging task in raising capital was initiated. A number of private equity funds were participating in the process and it was evident that no prospective investor would be satisfied with less than the majority of shares; hence the operational control was to be lost either way. However, as the due diligence was complete and a closing was near, a new financing solution was considered. The two current shareholders had the ability to invest private capital, and by increasing the ownership stake by MSEK 40, the bank would settle with renegotiated terms. In mid 2009, this issuance of new private capital was complete.

In 2008, the decrease in D/E ratio (2.6) is an effect of the prime amortizations which, with the progressive payback rate, became harder and harder to honor. When calculating the WACC and firm value we find,

$$WACC = 15.5\% \cdot \frac{126}{126 + 324} + 8.3\% \cdot (1 - 26.3\%) \cdot \frac{324}{126 + 324} = 8.7\%$$

$$V = \frac{29.2 \cdot (1 - 26.3\%)}{8.74\%} = 246$$

This is remarkable since it reflects an increasing firm value (+7.8%) in comparison to the previous year. This could be described as an effect of the fact

that the WACC calculations do not take into account the external pressure of creditors. Even though EBIT shows a comparable increase, it is still below the limit to sufficient serve the debt agreement.

4.4 Current situation

Today, most negative effects from the downturn have faded. Sales and profits are experiencing satisfying growth and covenants are easily met due to the renegotiated loan-terms. Short after the completion of capital issuance, the value of the company doubled since the takeover threat was diminished and strong corporate governance can once again carry out the core business in a proper manner. The debt service capacity is no longer stressed due to remodeled forecasts and a more conservative repayment approach, with a less progressive rate.

For the time being, the forth going of acquisition-led expansion have halted for the benefit of increased organic growth, which naturally, bears less risk but still generates short payback periods and favorable return on investment. In the short term, the goal is to maintain a steady repayment rate and settle the debt in two years. What lies beyond that horizon is still uncertain in terms of new investments.

The current debt-to-equity ratio is 1.2 and thus gives the following financial situation,

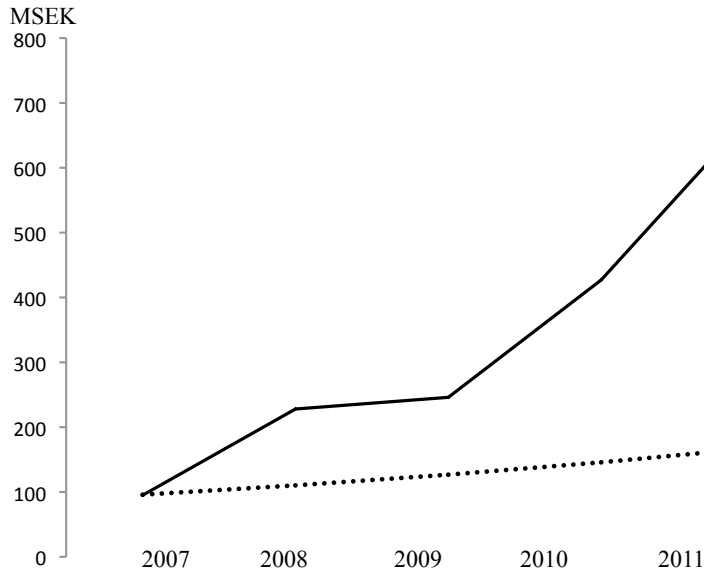
$$WACC = 15.5\% \cdot \frac{209}{209 + 169} + 6.9\% \cdot (1 - 26.3\%) \cdot \frac{169}{209 + 169} = 10.84\%$$

Which generates the firm value of,

$$\frac{101 \cdot (1 - 26.3\%)}{10.84\%} = 686.5$$

Hence, according to the WACC valuation, the firm value has experienced a steady growth over time, despite the periods of financial distress. In addition the actual growth, the dotted line illustrated in figure 4:1 represents the Group's hypothetical value with an unlevered, 15% annual growth. This approach would have generated an approximate firm value of MSEK 167.

Figure 4.1: Firm value development and *what-if* analysis

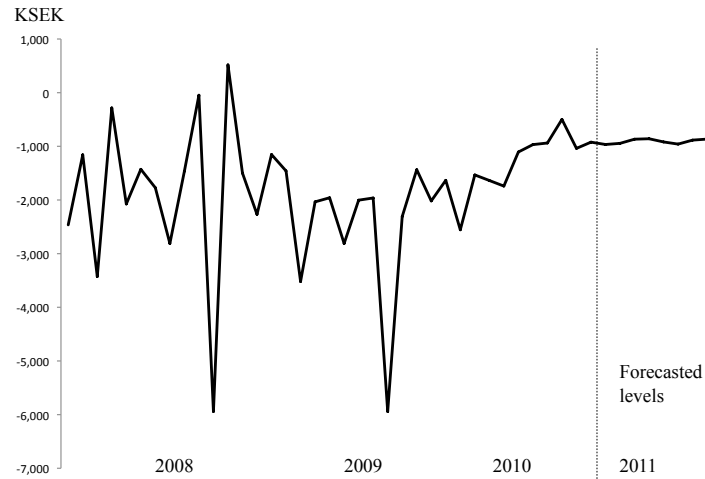


Graph illustrates actual firm value growth with a ending value of MSEK 686.5 and the hypothetical value progression of unlevered financing, assuming a 15% annual growth. This example clarifies one of the CFO's and shareholders main predicament: that the financial incentive for leverage is predominate to almost any potential trade-off.

4.5 Debt service capacity overview

The interest between the years of 2007-2009 was, as already mentioned, progressive. Basically, the firm's ability to honor the debt is measured by the amount of free cash flow. The main drivers for this is thus cost reductions and increasing sales. The primary goal during the financial crisis was to increase profitability by higher sales and margins by aggressive campaigning operations, however, this solution appeared to be insufficient and a cost reduction program was launched. Working hours in the stores experienced the greatest cutoffs and proved to be a vital part in the overall profitability of the Group.

Figure 4.2: Monthly interest levels

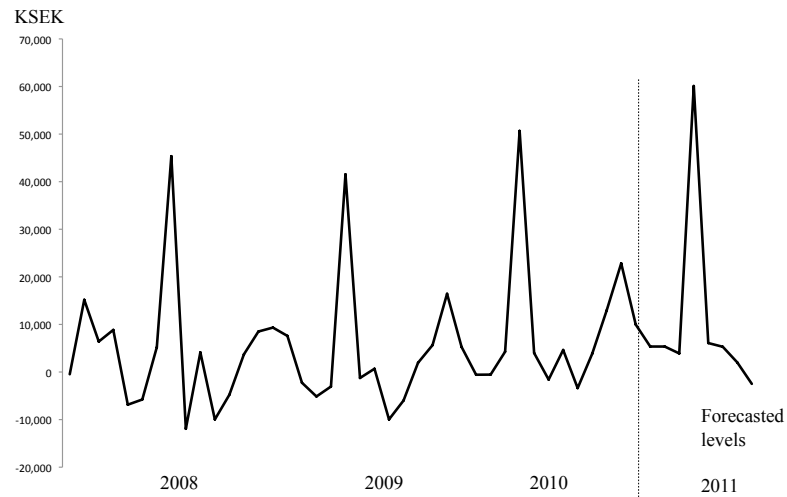


Development of the monthly payables. As seen on the graph, the two major interest payments were due after the Christmas sales, which facilitated the payments.

The largest repayments were scheduled to March each year, reaching up to MSEK 6 in a single payment, as illustrated in figure 4:2. Such volatility of payments is to a extent stressful due to the fact that the irregularity of major cash outflows requires a minimum of equal levels of free cash flow. This solution made the debt service capacity highly dependent on the performance of the Christmas sales, which historically generates a significant level of free cash.

As seen in figure 4:2, the repayment rate staggered throughout this period. It is also obvious that the new bank agreement from late 2009 implies a much slower rate of repayment which is highly beneficial for the firms ability to maintain financial flexibility. Moreover, as the new debt service agreement was settled, the upper management could regain focus on commercial operations.

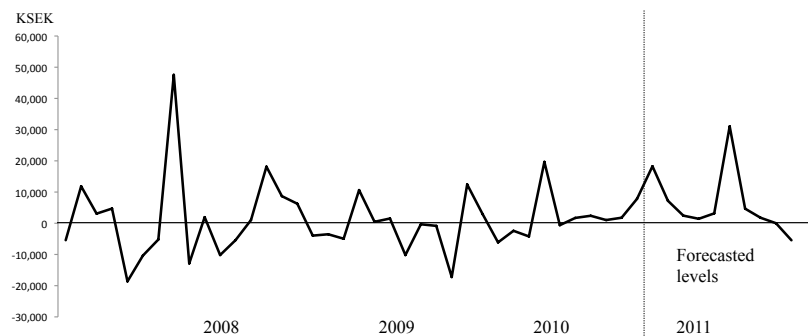
Figure 4.3: Monthly debt service capacity



Development of the monthly cash inflows. The four distinct peaks on the graph corresponds to the Christmas sales.

When adding the capacity to meet the debt, as illustrated in figure 4:3, it is somewhat shown that the Group managed to increase cash flow during the period. Nonetheless, the Group is still under financial distress during 2008. The four peaks are due to the Christmas sales.

Figure 4.4: Net cash flow



The net cash flow is presented in figure 4:4 and illustrates the monthly deficits during this period. On the yearly perspective, the net is on the other hand positive from 2009 and onwards.

Table 4.2: Debt service capacity overview (MSEK)

KPI	2008	2009	2010	2011
EBITDA	73	103	141	142
Change in working cap.	-37	23	-85	-9
CAPEX	-19	-21	-18	-35
Operating Cash Flow	17	105	38	98
Interest	-22.7	-25.5	-1.4	-12
Amortizations	0	-47.2	-26.2	-17.9
Taxes	3	-1.9	- 1.7	-16
Net Cash Flow	-2.7	30.4	8.6	52.1

As shown in table 4.2, the only year with negative net cash flow is 2008. This result is mainly driven by the increasing levels of working capital required by the new operations, such as instore faceliftning. The amortizations has not yet burdened the sheet due to the fact that the firm are in cash flow deficit and are simply unable to manage agreed upon repayment terms.

The following year, the earnings start to pick up due to higher margins and the initiated cost reduction program. In addition, the working capital decreases due to the closing of a few stores and lower stock levels. Further, the Group commenced the repayment of long-term loans with MSEK 47.2. The closing net this year measures MSEK 30.4.

The financial situation for 2010 is more favorable. The renegotiated bank terms implies reduced level of interest and debt repayment, which enables increased stock levels and thus higher sales. The overall performance of core operations experience a significant increase, even though the net is lower than previous year.

The 2011 data is gathered from the Groups internal forecasting. According to predictions, the EBITDA levels are remaining constant and due to lower amortization levels, the Group experience a net cash flow of about MSEK 52. If this is the actual case remains to be seen in the future.

This concludes the empirical data regarding capital structure management gathered in this study. This thesis will proceed with the findings and present those together with final remarks in the following chapter.

Chapter 5

Conclusion

This thesis has demonstrated the hardships of financial distress under an extreme macroeconomic environment. By evaluating the actions and consequences of a real-life case such as this, it is somewhat simple to conclude that there exist no plausible model covering all possible aspects of financing decisions. Many theories have tried to summarize and capture the essence of managerial trade-offs but failed.

In this context, the actions conducted by the Group are *mainly motivated* by the *confidence that economic growth is directly limited by the firms supply of capital*. Hence, the need for alternative financing was imminent, leaving the management with two choices: issuing debt or issuing equity. In 2007, this situation led to the decision to issue debt as a result of confidence that the equity was undervalued. This managerial behavior can be related to the market timing theory, which describes the financing decisions of the firm as a variable of information asymmetry. In this case, the investors may have had knowledge of market conditions which the shareholders lacked, or shareholders perception was biased due to their high stake. This led to the decision to issue more debt since it was considerably cheaper.

However, the timing to invest and lever the firm could not have been worse. As a direct result of the global downturn, in 2008, the firm was forced to increase the capital base and the shareholders were fortunate enough to have the ability to invest more private capital. If that option had not existed, they would have had no choice but to sell to an investment fund with, perhaps, no long-term interest in the company. In general, these events correspond very well to Myers theory of principle of least effort (1984). Since the firm already issued the types of financing with least effort, they then had to turn to the last resort, which is equity. In addition, we can conclude that no other academic model was applied by the Group in their obtaining of capital structure.

The fact that the Group is a private firm has great impact on the decisions of debt or equity issuing. Publicly traded firms can more swiftly control their financing since the stock price always is known by the market. Under those circumstances other factors, such as the credit rating, are of significantly more importance.

When evaluating the decision to lever the Group with debt, the values drawn from the WACC analysis show a significant increase in firm value which could most likely not be matched unlevered. The what-if analysis suggests that the approximate firm value in the end of 2010 would reach a level of MSEK 167, if unlevered, compared to MSEK 686 with debt. Hence, financial argument for leverage is evident but also implies, as history has shown us, an increased level of risk.

Noteworthy is the apparent relationship with net cash flow (figure 4:4, table 4:1) and firm value development (figure 4:1). In 2008, the firm value growth halted, which happened to correspond with the same year as the negative generation of net cash flow. The halted value-growth may have been directly related with the cash flow for several reasons. First, the firm's ability to maintain a solid market position and fully participate with the competition is greatly affected when struggling with financial deficits, which in turn affects the overall firm value. Second, the management may have lost their degree of involvement in the commercial operations in favor for the financial negotiations with stakeholders e.g., creditors or investors, which caused the organization to lose their edge and performance. Third, the deficit may have caused hardships with supplier relationships, e.g., lowered credit periods, which may be sincerely hard to handle with a stressed cash flow sheet.

5.1 Final remarks

The relevance of this topic seems to be undisputed and the general perception is that there is no consistent method to apply on any given business case because of the complexity of reality and the simplicity of models. This is how far the academic and professional research has come as of today. The most widely applicable approach may be the one presented by Goedhart et al. (2006), arguing that the firms should determine the capital structure as a supporter of their own business strategy and the main trade-off related to capital structure is the one between financial flexibility and fiscal discipline. With this philosophy in mind, we can conclude that KIN Group acted in accordance with their own strategy, which was to grow by capitalizing on their skills in retailing. Unfortunately, as the crisis appeared, the cushion to fall back on was not thick enough.

This thesis discusses the challenges and possibilities of an unlisted company. What require further research are similar, qualitative, studies conducted on public firms as the financial environment changes dramatically when publicly traded.

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