INTERMEDIATE FINANCIAL MANAGEMENT
FIN 362 B – SPRING 2017
FINAL EXAMINATION INFORMATION

The final examination will consist of a comprehensive case from a text titled CASES IN FINANCE, by Robert F. Bruner. The case is titled Brown-Forman Distillers Corporation. I have put on Blackboard the case, the author supplied spreadsheets and the additional questions that are required to be answered. Note that the additional questions are on page two of this document.

The original Brown-Forman Distillers Corporation case comes from an earlier edition of the Bruner text, it is not found in our present edition of the text book. The case being a classic amongst valuation cases is available on line at their updated, for the new textbook, website. The case has been further updated by Robert F. Bruner and was last revised on 04/02.

I will send via email the spreadsheets for this case that are in Excel. Please advise one member's email address you want them sent to for this information.

As per the course syllabus, the case is to be completed, as a group project, with a single written case turned in by 6:00 PM, Wednesday, May 10, 2017. This can be turned in earlier to my office or my mail box. Late papers will not be accepted, so plan accordingly.

The written final examination should be a group effort with each member making a contribution. In addition, no discussion of the case outside of the group or information developed by other groups should be used. Assumptions should be clearly stated if you feel that they are necessary, there are no omissions in this case, so any assumptions should not be necessary.

Please document and footnote all sources of information used as part of your solution, thus footnoting is required. It is very important that you turn in professional work as this final exam accounts for 15% of the grade for the course.

The length of the written final examination case can vary greatly, but counting exhibits the average is 10-15 pages.

Please see the second page for additional questions that must be answered for this case.

In addition to the case format, used from the Harrington text, that we used for most of our cases, both written and oral, address the following questions: (Note: We referred to this approach as the Macro and Micro approach in our discussion.)

Lastly, our Brigham textbook and the Bruner case book will be useful in helping to answer some of these questions, please footnote where appropriate for the material you take from these texts.

Note: Do not answer just these questions!!!!!!!!!!!!!!

1. What are the various approaches available for valuing Southern Comfort Corporation?

2. Based upon the DCF valuation approach (present value) should Brown Forman buy Southern Comfort at the asking price of $94.6 million?

3. The case states that Brown-Forman applies a discount rate of 14% (this is the WACC or required rate of return) to the evaluation of new projects. Based on qualitative information and quantitative analysis is this 14% rate correct?

4. Irrespective of your answer to Question #2, discuss why the acquisition target (Southern Comfort) fits Brown-Forman's strategic needs.

5. Lastly, what price should Brown-Forman offer Southern Comfort? Discuss what the likely reaction will be by Southern Comfort to negotiate to a lower price.

Brown-Forman Distillers Corporation

In early July 1978, W. L. Lyons Brown, Jr., president and chief executive officer of Brown-Forman Distillers Corporation, faced an important acquisition decision. The principal owners of Southern Comfort Corporation had approached Brown in May with an offer to sell the company at a price of $94.6 million. In preparing his response, Brown was evaluating the reasonableness of the asking price and the likely effects of the acquisition on Brown-Forman's share price.

As a leading producer, marketer, and importer of wines and distilled spirits (including the well-known Jack Daniel's brand), Brown-Forman ($457 million net sales) was the fifth-largest distiller in the United States, after National Distillers ($586 million), Seagram ($2,018 million), Heublein ($839 million), and Hiram Walker ($875 million).[1] How Brown had chosen to position Brown-Forman among its competitors would affect the appraisal of Southern Comfort.

Brown-Forman: Financial Goals and Performance

In 1977, Brown-Forman's management adopted new long-range financial goals regarding (1) hurdle rates for investment, (2) size of the capital budget through 1980, (3) target capital structure, and (4) dividend payout. The primary objective of these goals was to "increase the value of the stockholders' investment."[2]

The dividend payout ratio (all dividends paid divided by net income) was targeted at a range of 30 percent to 35 percent. Planned investment during the 1978–80 period included $86 million for advertising and promotion, $39 million in barreled whiskey inventory, and $19 million in new plant and equipment. Regarding capital structure, the ratio of total debt to total

[1]Net sales figures for all firms were from wine and distilled-spirits business lines only.
[2]*1978 Annual Report*, 3.

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tangible capital,[3] 26.6 percent at the end of 1977, was viewed as offering "considerable flexibility in financing investment opportunities with either debt or equity."[4] Finally, the target hurdle rate, calculated as the return on total capital employed,[5] was set at 14 percent for new capital projects in the distilling industry and 12 percent for investments in projects already in place.

The *1977 Annual Report* declared:

> While we are pleased with our 1977 results, in order to improve our return on total capital employed, we will be selective in pursuing new capital projects and will concentrate our efforts on improving the profitability of our present business. Management will actively pursue investments in new capital projects that have an anticipated return of at least 14 percent after taxes on the capital employed. At the same time, we will continue our efforts to expand the most profitable operations of the company. With respect to other areas of our business, your management is taking steps through price increases and closer attention to asset management to improve profitability. If the returns of these operations do not attain a higher level, management will consider channeling the capital supporting them into more-profitable projects, products, and acquisitions.

Exhibit 1 compares the financial performance of Brown-Forman with its largest competitors. The company had a relatively larger profit margin, higher growth rates, and stronger balance sheet than its major competitors. The *1978 Annual Report* noted:

> The Company's balance sheet is strong due to continued close attention to asset management. Our low debt/equity ratio and the excellent financial performance in recent years place the Company in a favorable position to assume higher levels of debt to finance acquisitions and other investment opportunities.

Value Line identified Brown-Forman as the "premier liquor company in the United States" and noted that the firm's major brands continued to grow despite a flat industry growth trend.[6] The company was expected to earn $2.45 per share in 1978 and to add another 15 percent to earnings per share in 1979.

Brown-Forman's income statement and balance sheet for the year ended April 30, 1978, are given in **Exhibits 2** and **3**. In 1978, two classes of stock existed for the company: Class A

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[3]"Total tangible capital" was defined as the sum of all interest-bearing debt, deferred income taxes, preferred equity, and common equity less intangible assets.

[4]*1977 Annual Report,* 15.

[5]"Return" was defined as the sum of net income (excluding extraordinary items), the after-tax cost of interest, the increase in deferred income taxes, and the amortization of intangible assets during the year. "Average total capital employed" was defined as the sum of all interest-bearing debt, deferred income taxes, and preferred and common equity averaged at year-end.

[6]This and following quotes are from *Value Line* (April 14, 1978): 350.

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