Sealed Air Corporation

In 1995 The Journal of Applied Corporate Finance *published a case study of the leveraging of the Sealed Air Corporation. Although the story is now somewhat old, it is a wonderful illustration of some of the incentive effects of leverage.*

Sealed Air Corporation manufactures a wide variety of packaging materials such as plastic packing bubbles and Jiffy padded envelopes.

As it entered 1989, Sealed Air was very conservatively financed with $33 million in total debt and over $54 million in cash. Thus, rather than borrowing cash, the company was actually a net lender. However, in June of that year Sealed Air dramatically changed its capital structure by paying a special one-time dividend of $40 a share. With about 8.25 million shares trading, the total cash payout amounted to almost $330 million, or close to 90% of the total market value of the firm's common stock. To help finance this special dividend, the company borrowed a total of $307 million. Thus, the company went overnight from being a net lender to being a very heavy borrower. Debt now amounted to 125% of the book value of the assets and 65% of their market value.

Until the change in capital structure Sealed Air's performance was no better than that of the industry as a whole. But the change was a prelude to a sharp improvement in the company's operating performance. In the following 5 years, operating profit increased by 70% while the asset base grew by only 9%. This improvement in profitability was more than matched by the company's stock market performance. The initial effect of Sealed Air's announced change in capital structure was a jump of 10% in the stock price. Over the next 5½ years the stock outperformed the market by 400%.

What then motivated the change in capital structure and what role, if any, did this change play in the company's subsequent performance?

Some of the gains from the change in capital structure may have come from the fact that the company was able to offset the interest payments against tax. But this does not appear to have been a primary motive. Instead, the change appears to have been management's response to

the realization that life at Sealed Air was in many respects too comfortable. For years patents had insulated the company from competition. Cash was plentiful. So the company never needed to think hard about requests to invest in new projects, and there was no sense of urgency in removing inefficiencies. In the management’s view it would take nothing less than a “crisis” to shake employees out of their complacency. The change in capital structure was just such a crisis.

The sharp increase in debt levels meant that cash was no longer abundant for it was now needed to pay the debtholders and was literally essential to the company’s survival. Thus managers now felt under pressure to make those efficiency gains that previously had not seemed worthwhile. As employees became aware of the need for more effective operations, it was possible to decentralize decision making within the company and to install a more effective system of performance measurement and compensation. The result was a sharp increase in profit margins and a reduction in the working capital and fixed assets employed to generate each dollar of sales. It seemed that the capital structure change had succeeded in kickstarting a remarkable improvement in Sealed Air’s performance.

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