

 American Greetings

March 2012

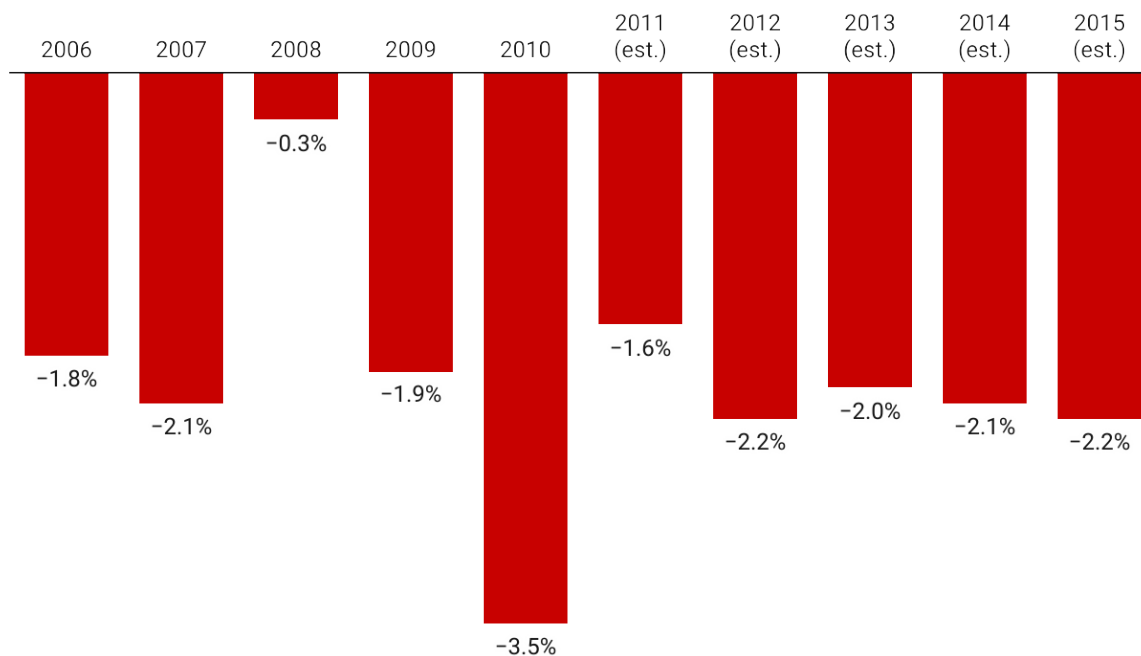
Stock Repurchase Proposal

Presented By
Andrew Rodriguez

I. Overview

American Greetings Corporation (AG), a leader in the greeting card industry, faces significant challenges in a rapidly evolving market landscape. The company, along with its subsidiaries Carlton Cards, Gibsons, Recycled Paper Greetings, Papyrus, and DesignWare, is grappling with a persistent annual decline in the U.S. greeting card market.

Total U.S. Greeting Cards Sales (Actual and Forecast)



The greeting card industry is experiencing a paradigm shift because of the rising popularity of digital communication platforms. This trend has precipitated several financial and strategic hurdles for AG.

i. Financial Performance Decline

- Revenue decreased at an annual rate of 2.95% from 2006 to 2010.
- Net income fell from \$87 million in 2010 to \$81.76 million in 2011, despite a 7% increase in revenue.
- AG's stock price plummeted to \$12.51 by December 2011, a significant drop from its 52-week high of \$24.01 in April 2011.
- The company's overall financial valuation has diminished significantly, as evidenced by the declining stock price and fluctuating net income.

ii. Strategic Financial Decision

- In response to the current low equity situation, AG is considering a substantial \$75 million stock repurchase initiative, to be funded through long-term debt. This proposal reflects the company's attempt to bolster shareholder value in a challenging market environment.

iii. Industry Outlook Dilemma

- Total U.S. greeting card sales have declined by 9.21% since 2005.
- AG must carefully evaluate whether to adopt a bullish or bearish stance on the future of the greeting card industry.

This situation requires a comprehensive analysis of market trends, consumer behavior, and potential growth opportunities. AG must consider digital transformation strategies, diversification of product offerings, and innovative approaches to maintain its market position and drive future growth.

The company's decision regarding the stock repurchase should be weighed against other potential investments in technology, marketing, or product development that could help counter the declining market trends. AG should explore ways to leverage its strong brand portfolio and extensive distribution network to generate additional revenue streams and enhance shareholder value.

As the industry continues to evolve, AG's ability to adapt to changing consumer preferences, embrace digital solutions, and optimize its operational efficiency will be crucial in determining its long-term success and market resilience.

II. The Problem

i. Market Contraction

- The greeting card market is experiencing a steady 2% annual decline, with projections showing further contraction.
- Industry analysts at Mintel forecast a best-case scenario of a 4% market decline over the next four years (2012–2015), with a worst-case projection of a 16% decline.

ii. Shifting Consumer Preferences

- The rise of digital communication—particularly social media—has significantly impacted traditional greeting card sales.
- This shift is especially pronounced among younger demographics, who increasingly opt for digital alternatives.

iii. Financial Performance

- AG has experienced a substantial decrease in product demand, stock price, and overall financial valuation in the past two years.

American Greetings Stock Price



iv. Increased Marketing Expenditure

- To combat these challenges, AG increased its marketing expenditure by \$10 million in Q3 2011. This strategic move aims to stimulate demand and maintain market share in a contracting industry. However, the effectiveness of this approach remains to be seen.

v. Seasonal Impact

- The decline in demand is particularly noticeable during the Christmas season, traditionally a strong period for greeting card sales.

vi. Consumer Behavior Change

- Recent surveys indicate a decline in paper card purchases, with the percentage of consumers buying cards within a three-month period falling from 59% to 52%.

In light of these challenges, American Greetings faces a critical decision:

Should the company proceed with a \$75 million stock repurchase program during this period of low equity valuation?

This decision requires careful consideration of several factors:

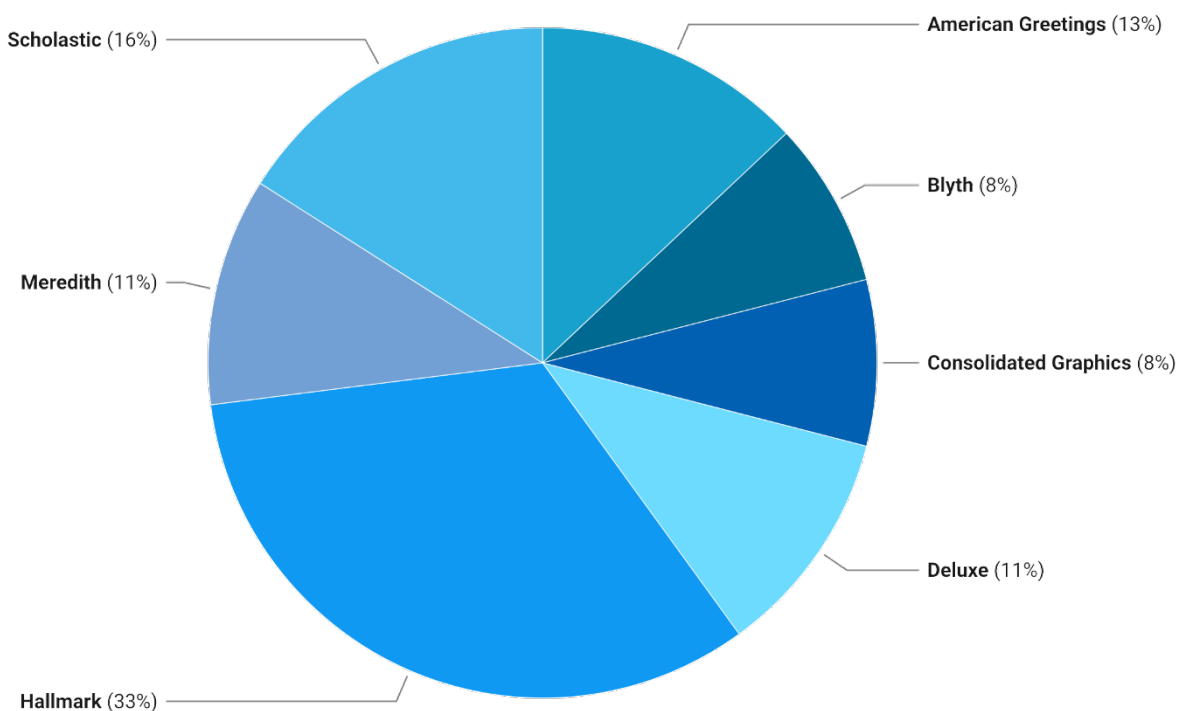
- Market Outlook:** AG must decide whether to adopt an optimistic or pessimistic stance on the future of the greeting card industry.

- **Innovation and Adaptation:** The company needs to evaluate its strategies for digital transformation and product innovation to remain competitive in the changing market.
- **Financial Implications:** The stock repurchase could potentially boost shareholder value, but it must be balanced against the need for investment in new technologies and marketing initiatives.
- **Long-term Viability:** AG must consider how this decision aligns with its long-term strategy for navigating the evolving landscape of the greeting card industry.

III. Market Overview

American Greetings Corporation (AG) stands as a formidable player in the greeting card industry, securing its position as the third-largest company behind Hallmark and Scholastic. Despite its strong family roots, AG has evolved into a widely held public entity. AG's ownership includes significant stakes from prominent institutional investors such as MAM Investments (10.6%) Dimensional Fund Advisors (10.5%) BlackRock (7.9%) and LSV Asset Management (6.7%).

Industry Market Share



i. Industry Contraction and Share Price Decline

The greeting card industry has been experiencing a persistent decline, with annual sales decreasing by approximately 2% since 2005. This contraction has had a direct impact on AG's financial performance and perception by investors, resulting in a concerning drop in share price to \$12.51 by the end of 2011. The market's shrinkage is primarily attributed to the rise of alternative forms of expression, particularly social networking platforms and digital greeting cards.

ii. Consumer Behavior and Market Outlook

While digital alternatives have gained traction, traditional greeting cards still maintain a substantial market presence. A 2010 survey found that 52% of U.S. participants had purchased a greeting card within the last three months, demonstrating ongoing demand for traditional greeting card products.

However, industry analysts project a continued contraction of the greeting card market. Mintel, a respected industry analyst firm, estimates that the market has already contracted by 9% since 2005 and predicts further decline. Their projections range from a best-case scenario of a 4% market decline over the next four years to a worst-case scenario of a 16% decline.

iii. AG's Response to Market Challenges

In response to these challenges, AG has implemented several strategies:

- **Digital Integration:** The company has introduced electronic cards and online platforms to cater to changing consumer preferences.
- **Customization:** AG has placed kiosks in retail stores, allowing customers to personalize their greeting cards.
- **Expanded Distribution:** They have extended their presence to dollar stores, broadening their market reach.
- **Diversification:** AG owns and licenses popular characters such as Care Bears and Strawberry Shortcake, creating additional revenue streams.

iv. Financial Performance

Despite AG's strategic efforts to address market challenges, their valuation ratios remain at the bottom of its comparable company group.

- **Price-to-Earnings (P/E) Ratio:** 6x
- **Enterprise Value to EBITDA Ratio:** 3.5x
- **Market-to-Book Ratio:** 0.75x

AG's strategic initiatives and the continued consumer demand for traditional greeting cards provide potential avenues for growth and stability. The upcoming years will be critical for AG to prove that it can adapt to technological advancements transforming the industry landscape.

IV. Comprehensive Valuation Analysis

To establish a comprehensive valuation for American Greetings (AG), we employed a rigorous analytical process combining both quantitative and qualitative assessments. This approach ensures a thorough understanding of AG's current market position and future potential.

i. Scenarios

To enhance the accuracy of our analysis, we developed three distinct scenarios:

- **Base Scenario:** This scenario assumes moderate growth and stable operations, serving as a primary benchmark by taking an average of bullish and bearish assumptions.
- **Bearish Scenario:** A conservative perspective that forecasts limited growth and declining operating margins.
- **Bullish Scenario:** Envisions optimal market conditions that result in strong revenue growth and improved margins.

ii. Key Assumptions

- **Risk Free Rate:** 2.8%
- **Market Risk Premium:** 5.5%
- **Fixed Asset Turnover Ratio:** 1.95 (based on historical data)
- **Working Capital Turnover:** Increasing by 0.5 year-over-year from 2012 onwards
 - **2012:** 6.0
 - **2015:** 7.5 (indicating improved liquidity for AG)
- **Long-Term Growth Rate (Perpetuity Growth)**
 - **Base Scenario:** 1.5%
 - **Bearish Scenario:** 0%
 - **Bullish Scenario:** 3%
- **Operating Margins**
 - **Base Scenario:** 7%
 - **Bearish Scenario:** 5%
 - **Bullish Scenario:** 9%

iii. Free Cash Flow Forecast

Utilizing management's insights on revenue growth and operating margins, we calculated future free cash flows under each scenario. This method allows for nuanced valuation, reflecting both optimistic and pessimistic market conditions and their impact on AG's financial health.

Forecasted Free Cash Flows

Scenario	2012	2013	2014	2015
Bullish	\$136,222,685	\$99,183,447	\$92,647,113	\$87,086,329
Bearish	\$136,455,813	\$93,113,452	\$79,811,530	\$67,123,931
Base	\$136,313,673	\$96,058,619	\$86,004,339	\$76,646,830

iv. Cost of Capital (WACC)

To determine an appropriate discount rate, we calculated AG's Weighted Average Cost of Capital (WACC) using industry-standard methodologies and company-specific data.

Cost of Equity

Derived via the Capital Asset Pricing Model (CAPM), incorporating:

- **Risk-free rate:** 2.8%
- **Beta:** 1.63
- **Market risk premium:** 5.5%

Cost of Debt

- **Current bond rating:** BB+ (highest in the industry)
- **Interest rate on debt:** 5.8%

Capital Structure Weights (from 2011 balance sheet)

- **Long-term debt:** \$235 million
- **Shareholders' equity:** \$752 million

WACC Industry Comparison

- **AG's WACC:** 9.8%
- **Median industry WACC:** 10.12%
- **Average industry WACC:** 9.12%

While AG's WACC of 9.8% is higher than the industry average of 9.12%, indicating slightly higher risk, it is below the median industry WACC of 10.12%. This suggests that AG is less risky than most of its industry peers, presenting a relatively stable investment for current and future shareholders.

V. Results without Share Repurchase

To assess AG's value under various market conditions, we employed a Discounted Cash Flow (DCF) model. The terminal value for each was calculated as an average of the perpetuity growth and AG's 2011 enterprise value.

i. Base Case

- **Enterprise Value:** \$889 million
- **Equity Value:** \$826 million
- **Implied Share Price:** \$21.57

ii. Bearish Case

- **Enterprise Value:** \$789 million
- **Equity Value:** \$726 million
- **Implied Share Price:** \$18.96

iii. Bullish Case

- **Enterprise Value:** \$1.035 billion
- **Equity Value:** \$972 million
- **Implied Share Price:** \$25.38

These valuations were derived using key financial drivers including free cash flow forecasts, revenue growth projections, weighted average cost of capital (WACC), tax rates, and terminal value calculations. The terminal value for each scenario was calculated as an average of the perpetuity growth method and AG's 2011 enterprise value, providing a balanced perspective on the company's long-term value.

To arrive at the equity value, we subtracted AG's total debt of \$235 million and added back cash and cash equivalents of \$172 million from the enterprise value in each scenario. The implied share price was then calculated by dividing the equity value by AG's 38.3 million outstanding shares as of the end of 2011.

VI. Results with Share Repurchase

To accurately evaluate the impact of a \$75 million share repurchase on the company's equity value, we conducted a comprehensive analysis of the company's capital structure and financial metrics. This analysis provides insight into the potential benefits and implications of the proposed share repurchase strategy.

Debt Position

- **Current long-term debt:** \$235 million
- **Additional debt for repurchase:** \$75 million
- **Resulting total debt:** \$310 million

Equity Adjustment

- **Current outstanding shares:** 38.32 million
- **Shares to be repurchased:** 6 million (at \$12.51 per share)
- **Total cost of repurchase:** \$75 million
- **Resulting outstanding shares:** 32.32 million

Market Capitalization

- **Pre-repurchase:** \$479.38 million (38.32 million shares at \$12.51)
- **Post-repurchase:** \$404.38 million (32.32 million shares at \$12.51)

Cost of Capital Analysis

- **Cost of Debt:** Remains constant at 5.8% (based on AG's BB+ bond rating)
- **Cost of Equity:** Increases from 11.8% to 12.4%

Weighted Average Cost of Capital (WACC)

- **Pre-repurchase WACC:** 9.8%
- **Post-repurchase WACC:** 9.63% (reflecting the increased use of debt financing at a lower cost than equity)

i. Base Case with Share Repurchase

- **Enterprise Value:** \$900 million
- **Equity Value:** \$763 million
- **Implied Share Price:** \$23.61

ii. Bearish Case with Share Repurchase

- **Enterprise Value:** \$797 million
- **Equity Value:** \$659 million
- **Implied Share Price:** \$20.39

iii. Bullish Case with Share Repurchase

- **Enterprise Value:** \$1,052 million
- **Equity Value:** \$915 million
- **Implied Share Price:** \$28.31

VII. Recommendation

Based on a comprehensive analysis of American Greetings' (AG) financial position and market conditions, we strongly recommend proceeding with a \$75 million share repurchase program, financed through long-term debt at a 5.76% interest rate. This recommendation is supported by the following key factors:

i. Undervalued Share Price

AG's current market price of \$12.51 per share (as of 2011) is significantly undervalued across all projected scenarios. Our analysis indicates that the implied share price ranges from \$18.96 to \$25.38 without a stock repurchase, suggesting substantial upside potential.

ii. Enhanced Shareholder Value

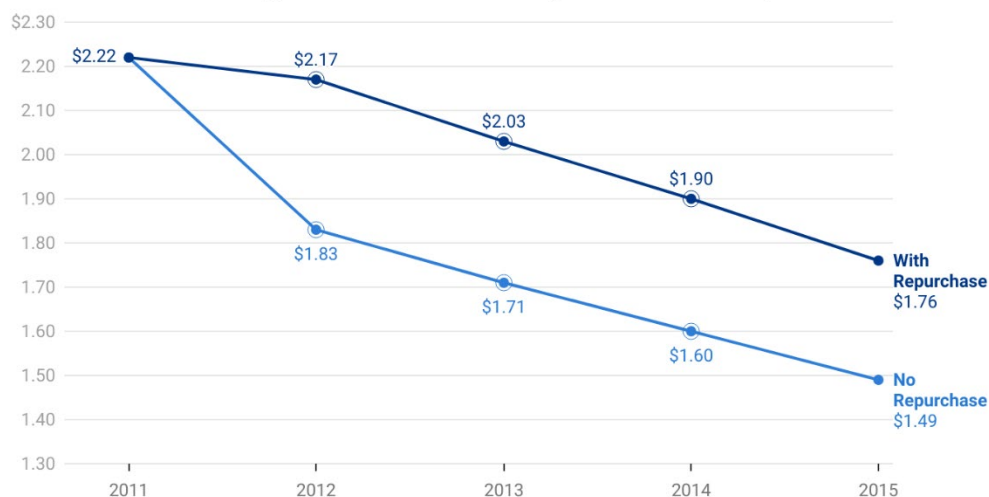
Following the proposed \$75 million repurchase, our forecasts indicate substantial implied share price appreciation:

Share Price Appreciation

Scenario	Pre-Repurchase Implied Share Price	Post-Repurchase Implied Share Price
Base	\$21.57	\$23.60
Bearish	\$18.96	\$20.39
Bullish	\$25.38	\$28.29

These projections demonstrate the potential for significant value creation for shareholders, even in challenging market conditions. The repurchase program is will also positively impact key financial metrics, most notably Earnings Per Share.

American Greetings Forecasted EPS (Base Scenario)



iii. Financial Impact and Market Perception

This initiative aligns with AG's successful track record of share repurchases, having bought back nearly \$100 million in shares through three programs since 2007. Implementing this program will signal strong confidence to investors in AG's long-term growth prospects and financial stability, particularly crucial given the challenges facing the greeting card industry.

American Greetings Stock Repurchase History

Period	Total Number of Shares Purchased	Average Price Paid per Share	Approximate Dollar Value of Shares Purchased
December 2007	1,863,900	\$22.75	\$42,403,725
January 2008	1,494,672	\$19.00	\$28,398,768
February 2008	1,300,000	\$20.40	\$26,520,000

iv. Comprehensive Scenario Analysis

Our recommendation is based on thorough analyses of base, bullish, and bearish scenarios, ensuring that the share repurchase strategy remains viable across various market conditions. This approach mitigates potential risks associated with market volatility.

v. Cost of Capital Considerations

The share repurchase is expected to have a minimal impact on AG's cost of capital. While the cost of equity may increase slightly from 11.8% to 12.4% due to a marginal increase in beta, the overall weighted average cost of capital (WACC) remains favorable for this initiative.

vi. Implementation Strategy

- Finance the entire \$75 million share repurchase through long-term debt at an interest rate of 5.76%.
- Execute the repurchase program strategically over a defined period to minimize market impact and optimize share price.
- Communicate the program effectively to shareholders, underscoring AG's confidence in its growth trajectory and dedication to increasing shareholder value.
- Continuously monitor market conditions to adjust the repurchase strategy as needed to safeguard maximum effectiveness.

The proposed \$75 million share repurchase program represents a timely and strategic opportunity for American Greetings to capitalize on its undervalued share price, enhance shareholder value, and reinforce investor confidence in the company's long-term prospects. This initiative aligns with AG's historical success in share repurchases and is supported by comprehensive financial analysis across multiple market scenarios.