FIN 6996: Corporate Finance
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Hansson's Private Label

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INTRODUCTION

Hansson Private Label (HPL) is a manufacturer that offers a range of personal care products such as soap, shampoo, mouthwash, shaving cream, and sunscreen sold under brand label or HPL's retail partners. HPL is currently partnered with supermarkets, drug stores, and mass merchants. HPL's mission is, "to be a leading provider of high quality label personal care products to America's leading retailers." During a meeting Tucker Hansson, CEO, proposed a project to expand the production capacity. This expansion would require a $50 million investment in order to expand the production capacity.

In 2007, HPL's largest retail customer had reached out and wanted to significantly increase HPL's share of their private label manufacturing. Given that HPL was already operating near full capacity which it would need to expand to accommodate this customer. The customer would commit to only a three-year contract – and expected a go/no-go commitment from Hansson with 30 days.

OBJECTIVE

This case study will focus on the following deliverables:

- Recommendations to CFO Sheila Dowling, Robert Gates, and Tucker Hansson.
- Industry breakdown.
- Hansson's position in the industry.
- Evaluate Robert Gates assumptions.

COMPANY BACKGROUND

HPL was purchased by Tucker Hansson in 1992. HPL was bought for $42 million which $25 million was Hanson's savings and $17 million was debt. Hansson is known as a serial entrepreneur with nine years of experience. His experience is composed of buying manufacturing companies and selling them after improving their efficiency in order to make profit. HPL's goal has been to capitalize and increase their market share.

Company Focus

The company focuses on manufacturing efficiency, expense management, and customer service. HPL has acquired business with major national and regional retailers giving them the advantage to increase their sales.

HPL is also known for being a conservative company:

- Never exceeding their capacity.
- Any new facility had to operate with at least 60% of the capacity utilization.
- Currently there are four plants operating at 90% of capacity.
- Maintaining modest level of debt to avoid risk of financial distress.

EXPANSION OBJECTIVE

Hansson's aim is to expand its production capacity to meet a large customer's demand. This investment proposal will cost $50 million, and the contract will be for a duration of 3 years.

The funds will be raised through debt financing, which is double the debt that the company currently holds. Profits per unit are expected to double due to the 50% reduction in COGS on Private Label products.

This investment is claimed to grow relationships with its largest customer, who is currently experiencing growth in sales. Competitors, on the other hand, are expected to restrain from expanding upon learning that Private Label signed a 3-year contract. Volume of units is expected to be growing at 100 bps, and prices on products are expected to grow at 170 bps annually. Finally, retailers are assumed to hold more of Private Label products due to their low COGS.

Potential Risks

The proposed expansion project for this company holds several risks and unknowns. The first risk is whether the customer will extend the contract after the 3-year period. This is accounted as a risk since the company is heavily relying on its large customer throughout this investment. Second, the risk of financial distress will grow upon acceptance of this project. Doubling the number of debt that Private Label has accumulated over the past several years is one of the main factors behind this risk.

Another factor that raises a flag for financial distress is the concentration of Hansson's wealth into a single non-diversified investment. This investment will also cause fixed costs to grow at an annual basis. Moreover, Private Label relies heavily on its retailers to sell its products. Retailers have a limited number of shelf space that is significantly competed for. An unknown is whether Private Label will be guaranteed additional desired shelf space after increasing its capacity through this expansion.

It is also assumed that stores will increase its inventories with Private Label products and decrease branded products. However, it is not guaranteed that stores will be taking such risk and increasing the likelihood that its customers will find their favorite branded items out-of-stock. An unforeseen risk may also be the probability of losing a customer. Private Label's financials reveal a high Cash Conversion Cycle (CCC). This high CCC puts the company at risk when it decides to expand on its production capacity.

Financial Ratios

We have evaluated Private Label's financial standing by computing several ratios and listing a few financial facts:

- After-tax cost of Debt: 4.65% (assuming 7.75% before interest tax shields)
- Current Ratio 2007: 2.85x
- Coverage Ratio 2007: 20.42x
- Quick Ratio 2007: 1.69x
- Inventory Turnover 2007: 8.64x
- Return on Assets 2007: 10.11%
- Debt-to-Assets 2007: 29.65%

INDUSTRY ANALYSIS

The personal care market included hand and body care, personal hygiene, oral hygiene, and skin care products. U.S. sales of these products totaled $21.6 billion in 2007. The market was stable, and unit volumes had increased less than 1% in each of the past four years from 2007.

HPL's Market Segments

Consumers purchase general care products mainly through retailers in five primary categories:

1. Mass merchants – Walmart.
2. Club stores – Costco.
3. Supermarkets – Kroger.
4. Drug stores – CVS.
5. Dollar stores – Dollar General.

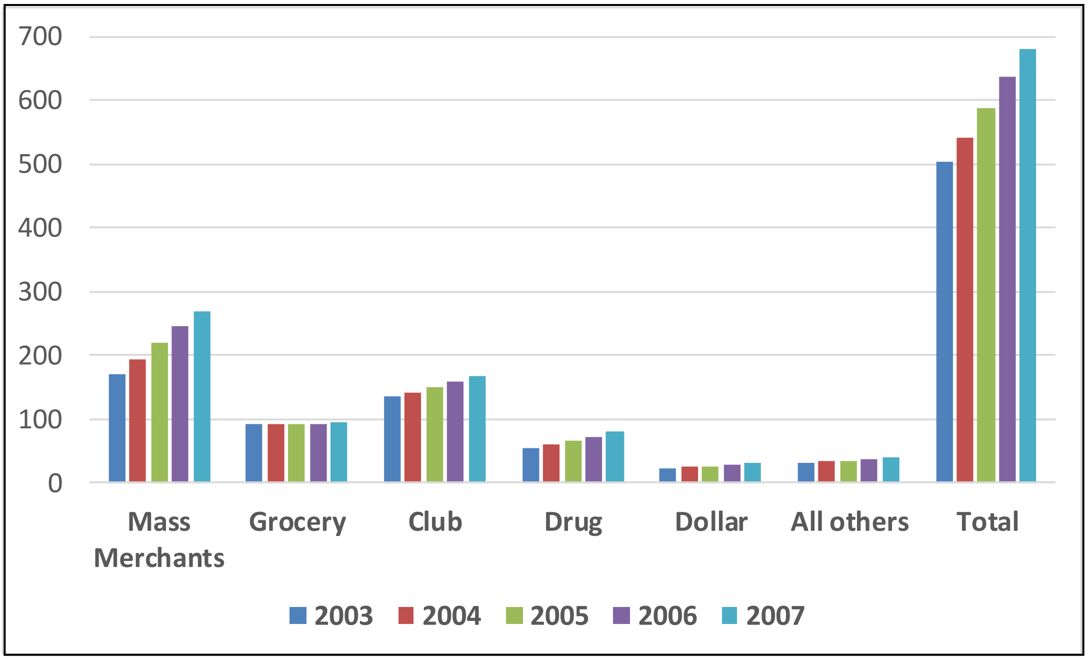
The firm generated $681 million in sales in 2007 through retail partners, which included: Supermarkets, drug stores, and mass merchants.

HPL Market Sales

Sales in (US$ millions)

Channel	2003	2004	2005	2006	2007
Mass Merchants	170	193	220	247	268
Grocery	91	92	92	92	94
Club	136	141	149	159	167
Drug	55	60	66	73	80
Dollar	22	24	26	29	32
All others	31	33	34	37	40
Total	**$505**	**$543**	**$587**	**$637**	**$681**

HPL's Sales into Retail Channels



Bloomberg S&P Analysis

12 Months Ending	2016 Y 12/30/2016	2017 Y 12/29/2017	Current 07/18/2018	2018 Y Est 12/29/2018	2019 Y Est 12/29/2019
Valuation Metrics					
Price/Earnings	20.56	21.70	21.31	17.62	15.97
Price/Earnings, Positi...	19.66	21.48	21.07	17.60	15.96
Price/Earnings before...	23.37	23.92	23.80		
Price/Book Value	2.93	3.27	3.39	3.23	2.98
EV/Sales	2.31	2.53	2.56	2.43	2.32
EV/EBIT	17.89	18.88	19.22		
EV/EBITDA	12.40	13.23	13.57	11.59	10.75
Dividend Yield	2.09	1.89	1.84	1.92	2.07
Fundamentals					
Gross Margin	33.59	33.72	33.65		
Operating Margin	12.77	13.83	13.74		
Profit Margin	8.87	9.19	9.49		
Return on Assets	2.73	2.88	3.03	3.56	4.32
Return on Equity	13.12	13.64	14.35	18.58	19.84

EXPANSION PROJECT

Robert Gates, HPL's Executive Vice President of Manufacturing led a team that developed a proposal aimed to expand HPL's relationship with its biggest customer. The expansion would also create the opportunity to grow HPL's other customer relationships. This level of commitment to the investment and incurring the associated debt would significantly increase HPL's annual fixed costs and its risk of financial distress may substantially increase. The sales that support the capacity growth would come, from HPL's largest customer which may cause

Investment Proposal

$ in Millions **Cost Components:**	**Amount**	**Est. Life**	**Depr'**	**% Maintenance**	**Cost of Maintenance**
Facility Expansion	$10,000	20	500	0	$500
Manufacturing Equipment	20,000	10yrs.	2,000	5.0%	1,000
Packaging Equipment	15,000	10yrs.	1,500	5.0%	750
Working Capital (1)	12,817			0.0%	
Total Investment	**$57,817**		**$4,000**		**$2,250**

(1) The increase in working capital is not expected to occur upfront at the time of the initial investment. It is assumed to take place throughout the year and should be considered as part of the 2009 cash flows.

Sum of Discounted Cash Flow	$12,076
Cost if Capital (Opportunity Cost	9.3%

NPV of Future Cash Flows	$6,131
Less: Today's Investment	(45,000)
Project Valuation	($38,869)

ANALYSIS

Our analysis focuses on HPL's performance from 2003 to 2007. Factors associated with HPL's financials, capital structure, and valuation from 2003 to 2007 will be identified for determinations in recommendation. Accompanied with this document is an excel spreadsheet analysis that's fully dynamic and provides for technical support.

HPL's Financials

Hansson's Private Label has experienced continued revenue growth of 8% average from 2003 to 2007. HPL has a sustained profit margin of 18.6% over the same period. With COGS and SG&A being a premium in the consumer industry which accounts for the low Net Income Margin of 5%.

Capital Structure

The capital structure consists of $54.8 million in Long-term debt and $58.1 million in Accounts Payable taken directly from the balance sheet.

Debt	Amt	Weights
LT Debt	54.8	48.5%
ST Debt	58.1	51.5%
Total	**$112.9**	**100%**

Debt	$112.9	30%
Equity	$267.9	70%
Total Capital	**$380.8**	**100%**

Assumptions

The 10-year Treasury rate of 3.75% was used as the baseline number for the current rate. The Market Risk Premium was provided at 5.00%. The tax rate of 40% was selected from the case study. A 7 times EBITDA with an estimated enterprise value of $514.5 million. The market cap is $465 million and $49.8 million in existing net debt with $57.8 million in new expansion debt. The total estimated debt is $107.6 million. The Debt/Value is 20.9% with the existing D/V at 9.7%.

Weighted Average Cost of Capital

The WACC was calculated by taking one minus Debt/Value percent then multiplied by the Cost of Equity percent. Then Debt/Value percent is multiplied by Cost of Debt then multiplied by one minus the tax rate is added to the previous statement.

Company:	Debt/ Value	Debt/ Equity	Equity Beta	Debt Beta	Asset Beta
Cathleen Sinclair	81.6%	444.9%	2.22	0.00	0.60
General Health & Beauty	16.5%	19.8%	1.95	0.00	1.74
Women's Care Company	10.0%	11.1%	1.14	0.00	1.07
Skin Care Enterprises	23.6%	30.9%	1.35	0.00	1.14
Average	**32.9%**	**49.1%**	**1.67**	**0.00**	**1.14**

Debt/ Value	Debt/ Equity	Asset Beta	Equity Beta	Cost of Equity	Cost of Debt	WACC
0.0%	0.0%	1.14	1.14	9.44%	7.75%	9.44%
5.0%	5.3%	1.14	1.17	9.62%	7.75%	9.38%
10.0%	11.1%	1.14	1.21	9.82%	7.75%	9.31%
15.0%	17.6%	1.14	1.26	10.05%	7.75%	9.24%
20.0%	25.0%	1.14	1.31	10.30%	7.75%	9.17%
25.0%	33.3%	1.14	1.37	10.58%	7.75%	9.10%

WACC using Capital Asset Pricing Model

The to adjustment to WACC was applying the CAPM to account for the Market Premium and risk free rate we adjusted the WACC with 2.69% risk free rate.

RECOMMENDATION

Robert Gates Recommendation

Restructure the agreement for a lower discount rate. A lower rate will impact NPV positively to avoid cannibalizing the company. Restructure the terms of the commitment for a longer period with reduce the principal payment obligations freeing up more capital. Utilizing more leverage may reduce working capital requirements.

Go/No-Go Recommendation

Our recommendation for the Go/No-Go commitment from Hansson's largest customer is going to be a No-Go based on our spread analysis. The analysis accounted for the terms and stipulations which effective the model by having a negative NPV, or serious risk of Hansson cannibalizing itself.

HPL Company Recommendation

Our recommendation for HPL is that is: Continue to grow revenue through current model. Adjust new products that focus directly on Mass Merchants and Club sales which account for almost 65% of total sales or $421.1 million in 2007. Rely on the Discounted Cash Flow statement as it gives a more accurate picture of the Hansson's financial stability.

CONCLUSION

Hansson's Private Label has experienced steady revenue growth and has offset much of their expenses and costs which is reflected in the balance sheet. Higher capital levels have also made the return to shareholders fall due to the higher financial leverage of 25%. Due to the competitive nature of the Consumer industry, many companies will have to adjust their business models to make up for the higher cost of doing business as well as the loss of some revenue sources.

APPENDIX

References

Bloomberg Terminal. (2018). " S&P Financial Analysis". Retrieved 18 July 2018.