**Hill Country Snack Foods**

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**Business Risk and Business Value**

Hill Country faces high competition in the snack food industry from giant corporations and smaller snack providers alike. The snack food industry has relatively low costs of entry and is already extremely diluted with brands offering wide arrays of products. Quality, flavor, and a large market presence is required to be a thriving snack food company.

Financial risk increases as the debt to capital ratio increases. For example, with a debt to capital ratio of 20%, Hill Country can cover their interest costs 36.9 times. However, with a debt to capital ratio of 60%, they can cover interest costs only 4.52 times. This isn’t always a bad thing. If Hill Country is being more aggressive in their investments, profits have the potential to skyrocket and the company can grow at an accelerated rate. Furthermore, the internal growth ratio begins to decline as the debt to capital ratio gets too large.

While financial risk increases with debt, firm value also increases up to a point. By relying more on debt and less on equity, dividends per share increases, up to $0.99 with a debt to capital ratio of 40%. That is a large increase versus the no-debt financing dividend per share value of $0.85. Earnings per share also increases with debt financing, rising to a high of $3.31 at the 40% debt to capital ratio. Stock price also rises if the company is more aggressive in their capital structure, rising to above $48 at the 40% ratio compared to the stock price of $41.67 with no debt. Having too much debt will decrease stock price however, down to $45.72 at the 60% ratio. Beyond those value advantages, the company also gets tax advantages by financing investments with debt, which will be discussed later. There are obviously pros and cons to being more aggressive in capital structure and financing.

**Target Capital Structure Recommendation**

We recommend an optimal capital structure with a 40% debt-to-equity ratio. This is based on our calculations of company risk, shareholder earnings, and positioning for future growth. Compared to all other scenarios we analyzed, this structure will maximize the Hill Country share price and dividend yield, while providing modest debt tax shield protection. This allocation provides an 8.38% reduction in income taxes paid. While a more aggressive position could increase earnings available to shareholders and the tax shield, we believe that the risk level based on a 40% debt-to-equity ratio is the sweet spot for future growth without sacrificing current stability. Most importantly, this strategy goes hand-in-hand with Hill Country’s core principle of maximizing shareholder value. Capital markets can react positively or negatively with debt issuances, and we believe that 3rd party analysts will agree that this recommended debt issuance will grow future earnings without assuming excessive risks. This should earn a positive reaction in capital markets with a target share price of $48.66, a 14.9% over the 2011 valuation.

**Strategy to Increase Leverage to Target Levels**

If Hill Country is confident in their financial position, they can increase leverage to establish a more aggressive capital structure which matches our recommendation. Equity can be decreased by traditional methods, such as share repurchase agreements and dividends to ownership. Contrarily, the easiest ways that debt levels can be increased is by selling bonds or taking on loans to pursue projects that otherwise wouldn’t have been possible. We recommend that Hill Country should issue debt until a 40% debt-to-equity ratio is achieved and put the raised cash to work pursuing high NPV projects.

**Arguments for an Aggressive Capital Structure**

Hill Country has traditionally been very risk averse, opting for steady growth while controlling costs and striving high efficiency in the competitive snack food market. However, Hill Country prioritizes maximizing shareholder value above all else and that mindset has led to their “steady, but unspectacular” revenue growth throughout the years. As CEO, to maximize shareholder value and to rocket profits, taking on some debt is a wise move for shareholders and the company.

Debt obviously increases the chances of organizational collapse, however, debt to finance large and *smart* projects can grow Hill Country Snack Foods to new levels if the return exceeds the interest costs. When financing all projects through equity (as you currently do), earnings per share will eventually decrease as more shares are issued to fund corporate investments, which is the opposite goal of Hill Country. Furthermore, by financing more projects with debt, there are tax advantages such as the debt being tax deductible and reducing the net cost of the projects. There is always the chance a project fails, but there are similar risks to the company whether the project is financed with debt or equity. You are going to lose money on a failing project either way. By being less risk averse and increasing project investments (more aggressive), profits can grow much faster in this competitive market. In the long run, by financing profitable projects with debt, taxes will be reduced, profits will grow at spectacular rates, and earnings per share will increase.

Grade 32/40

Comments:

Report: missing at least one summary table with main results.

- Earnings available to security holders is incorrect -> interest payments are missing.

- Change from actual missing for earnings and cash to security holders.

- Simulations in change in EBIT impact on Net Income are incorrect. You needed to obtain new EBIT, then deduct interest and taxes to get to updated Net Income.

Roberto Stein , Feb 25 at 4:02pm