



BRIEF CASES

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ERIK STAFFORD
JOEL L. HEILPRIN
JEFFREY DEVOLDER

Hansson Private Label, Inc.: Evaluating an Investment in Expansion

Introduction

On a frigid Sunday night in late February 2008, Tucker Hansson pored over a proposal developed by his firm's manufacturing team. It called for investing \$50 million to expand production capacity at Hansson Private Label (Hansson or HPL). For Hansson, a private company, this would be a significant investment. The company had not initiated a project of that magnitude for more than a decade, and the expansion wasn't without significant risk. It would be likely to double HPL's debt and to greatly increase customer concentration. This was a critical juncture for the firm Tucker Hansson had carefully built over 15 years. He wondered whether the return on investment would be large enough to justify the effort and risk. He also wondered about the best means of evaluating the potential investment.

HPL manufactured personal care products—soap, shampoo, mouthwash, shaving cream, sunscreen, and the like—all sold under the brand label of one or another of HPL's retail partners, which included supermarkets, drug stores, and mass merchants. The firm, whose sales had grown steadily over the years, generated \$681 million in revenue in 2007.

Three weeks earlier, HPL's largest retail customer had told Hansson that it wanted to significantly increase HPL's share of their private label manufacturing. Given that HPL was already operating near full capacity, it would need to expand to accommodate this important customer without "cannibalizing" a significant portion of HPL's existing business. The rub was, the customer would commit to only a three-year contract—and it expected a go/no-go commitment from Hansson within 30 days.

Although he was worried about risk, Hansson was equally invigorated by the prospects of rapid growth and significant value creation. He knew of numerous examples of manufacturers, both in private label and branded businesses, who had risked their future by locking in a strong relationship with a huge, powerful retailer. For many, the bet had delivered a big payout that lasted for decades.

HBS Professor Erik Stafford, Illinois Institute of Technology Adjunct Finance Professor Joel L. Heilprin, and writer Jeff DeVolder prepared this case specifically for the Harvard Business School Brief Case Collection. Though inspired by real events, the case does not represent a specific situation at an existing company, and any resemblance to actual persons or entities is unintended. Cases are developed solely as the basis for class discussion and are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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Hansson's employees had completed their fact-gathering and provided a multifaceted analysis of the proposed project, which he now held in his hands. The time had come to do a final analysis on his own and make a decision.

Company Background

HPL started in 1992, when Tucker Hansson purchased most of the manufacturing assets of Simon Health and Beauty Products. Simon had decided to exit the market after struggling for years as a bottom-tier player in branded personal care products. Hansson was a serial entrepreneur who had spent the previous nine years buying manufacturing businesses and selling them for a profit after he improved their efficiency and grew their sales. He bought HPL for \$42 million—\$25 million of his own funds and \$17 million that he borrowed—which was (and remained) the largest single investment Hansson had ever made. Hansson was seeking to capitalize on what he saw as the nascent but powerful trend of private label products' increasing their share of consumer-products sales. Although the concentration of his wealth into a single investment was risky, Hansson believed he was paying significantly less than replacement costs for the assets—and he was confident that private label growth would continue unabated.

Hansson's assessment of private label growth prospects proved to be prescient, and his unrelenting focus on manufacturing efficiency, expense management, and customer service had turned HPL into a success. HPL now counted most of the major national and regional retailers as customers. Hansson had expanded conservatively, never adding significant capacity until he had clear enough visibility of the sales pipeline to ensure that any new facility would commence operations with at least 60% capacity utilization. He now had four plants, all operating at more than 90% of capacity. He had also maintained debt at a modest level to contain the risk of financial distress in the event that the company lost a big customer. HPL's mission had remained the same: to be a leading provider of high-quality private label personal care products to America's leading retailers. (See Exhibit 1, which presents HPL's historical financial statements.)

The Market for Personal Care Products

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. The dollar sales growth of the category was driven by price increases, which were also modest, averaging 1.7% annually during the past four years. The category featured numerous national names with considerable brand loyalty. Branded offerings ranged from high-end products such as Oral-B in the oral hygiene category to lower-end names such as Suave in hair care. Private label penetration, measured as a percentage of subsegment dollar sales, ranged from 3% in hair care to 20% in hand sanitizers. (Exhibits 2 and 3 present data about private label sales and market share.)

Consumers purchased personal care products mainly through retailers in five primary categories: mass merchants (e.g., Wal-Mart), club stores (e.g., Costco), supermarkets (e.g., Kroger), drug stores (e.g., CVS), and dollar stores (e.g., Dollar General). As a result of significant consolidation and growth in retail chains over the past 15 years, manufacturers of consumer products depended heavily on a relatively small number of retailers that had a large national presence. To survive in the personal care category, manufacturers had to persuade large chains to carry their products, provide adequate and highly visible shelf space, and cooperate with product promotions. Many consumer-goods companies found it increasingly difficult to do so, as roughly 80,000 new products were launched each year, creating intense competition for shelf space.

The Private Label Industry

With private label brands, retailers rather than manufacturers controlled the production, packaging, and promotion of the goods. Although some large retailers had integrated vertically and owned the manufacturing facilities for their private label products, most retailers purchased their goods from third-party manufacturers. Some manufacturers produced private label products in addition to their branded goods (e.g., Kimberly-Clark), whereas others (e.g., Procter & Gamble) did not produce any private label products.

Historically, retailers had carried private label goods to offer consumers lower-priced alternatives to national branded goods. Over time, quality improvements in private label goods and their packaging led to increased acceptance by consumers. Acceptance was so widespread that 99.9% of U.S. consumers purchased at least one private label product in 2007, according to AC Nielsen. This greater acceptance led private label sales across all product categories to exceed \$70 billion in 2007.

Retailers had driven, and still drove, these increases in consumer acceptance. They could increase their profits by capturing a greater share of the value chain than they did with branded goods, on which manufacturer profits per unit could be twice those of the retailer, especially if the brand was well known (e.g., Crest toothpaste). With private label goods, retailers' cost of goods was as much as 50% lower than with branded products. Given the reduced cost, retailers could double their profit per unit sold despite lower selling prices. Gaining further consumer acceptance of private label goods and prices remained a huge opportunity for retailers, as these goods constituted less than 5% of sales in many product categories. In the \$21.6 billion personal care category, private label products accounted for \$4 billion of sales at retail (less than 19%), which translated to \$2.4 billion in wholesale sales from the manufacturers. Hansson estimated that HPL had a little more than a 28% share of that total (see Exhibit 4, which shows HPL's sales into its retail channels).

Investment Proposal

The investment proposal in Hansson's hands included the following elements:

Cost Components	Amount	Est. Life	Depr.
Facility Expansion	\$10,000	20yrs.	\$ 500
Manufacturing Equipment	20,000	10yrs.	2,000
Packaging Equipment	15,000	10yrs.	1,500
Working Capital ⁽¹⁾	12,817		0
Total Investment	\$57,817		\$4,000

⁽¹⁾ The increase in working capital is not expected to occur up front 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.

Note: Working capital is defined as accounts receivable plus inventory less accounts payable and accrued expenses. At the end of the project, working capital will be returned in an amount equal to accounts receivable less accounts payable.

The team that developed the proposal was led by Robert Gates, HPL's Executive Vice President of Manufacturing. They found the investment attractive because the additional capacity would allow HPL to expand its relationship with its largest customer (whose sales were growing in the U.S. and abroad) and generate an acceptable payback. The expansion would also create the opportunity to grow HPL's other customer relationships. Moreover, it might change the competitive landscape. Virtually all unit growth came from private label penetration gains that, although steady, were too

modest to support significant expansions by multiple producers. Knowing this, HPL's competitors might be deterred from expanding their production capacity in HPL's personal care subsegments—especially since HPL's announcement would be supported by a multiyear contract with a powerful customer.

However, the team acknowledged that the project presented risks unlike any that HPL had previously encountered. First, making this level of investment and incurring the associated debt would significantly increase HPL's annual fixed costs and its risk of financial distress should sales fall, costs rise, or both. Second, the sales that would support the capacity growth would come, at least initially, from what was already HPL's largest customer. Although HPL had a long and positive relationship with the customer, the demand could disappear at the end of the initial three-year contract.

Final Steps Toward a Decision

The annual capital planning process took place during an all-day working session hosted by Tucker Hansson each October. In the meeting, Hansson and his staff, including the managers of each facility, reviewed the capital requests and the related scoring prepared by CFO Sheila Dowling. They agreed on a prioritization of the projects, discussed the trade-offs of choosing various projects over others, and inquired into the opportunities and consequences of pursuing listed projects at lower levels of expenditure. The capital budget for the next year was typically finalized at Hansson's first staff meeting each December when any unanswered questions from the October session were addressed and the team reviewed the final plan one last time, including consideration of the latest forecast for EBITDA and the resulting capital budget for the following year.

For his part, Hansson usually relied heavily on Dowling's scoring to compare projects, but her typical approach to risk assessment was not helpful for this project. The size of the investment posed additional risk beyond what HPL typically contemplated. As a result, Hansson's questions about payback and risk had a more "macro" focus than usual; he wondered how much value the project would really generate, how much risk HPL should tolerate, how the company could mitigate the risks, and what the backup plans should be if unforeseen risks materialized. Making the wrong decision could have serious consequences stemming from increased capacity, fixed costs, and debt service. Moreover, Hansson knew that the cost of debt was likely to be pricy in terms of both interest expense and restrictive covenants, and that equity financing on favorable terms was extremely unlikely.

Hansson also knew his team was unhappy that his uncertainty was delaying the process. Furthermore, he realized that after several years without a big investment, the team was beginning to wonder whether he was transitioning into "harvest mode" and, therefore, whether their days with HPL were numbered. Hansson had to overcome his apprehensions and make a decision.

Pursuing this investment in capacity would close off all other investment opportunities for the foreseeable future: The company's financial position would be at the limit of Hansson's comfort zone, and HPL's managerial bench would be tapped out. He found the singular focus invigorating; indeed, the only investment opportunities HPL had evaluated in the past several years were incremental additions of new product types, which now seemed meager and unambitious. At the same time, Hansson was also grappling with the reality that most of his personal wealth was tied up in HPL, and a further investment of this magnitude would represent a concentration of personal risk.

Hansson needed to launch a final review of the request before he could comfortably give the go-ahead. The most vexing question for Hansson was related to the appropriate discount rate. He knew

that discount rates were intended to reflect the degree of risk in the underlying cash flows, but he also knew that the choice of discount rate could significantly affect a project's viability. HPL's practice had always been to use an estimate of the company's WACC as the discount rate for capital budgeting projects. In Hansson's mind, that made sense because all of HPL's capital budgeting projects were in its one line of business, manufacture of private label personal care products. However, Hansson now wondered whether the proposed project should be evaluated using the historical WACC. After all, the company was taking on more debt, and the project could very well change the risk profile of the firm.

With all of this in mind, Hansson had asked Dowling to prepare a range of potential discount rates (shown in **Exhibit 7**). To create her table, Dowling estimated HPL's enterprise value at 7.0x last fiscal year's EBITDA, which reflected the multiple of valuation for several recent transactions in the industry. Using the comparable company information shown in **Exhibit 6**, she considered her valuation to be both conservative and reasonable.

The portion of the WACC analysis with which Dowling was most troubled related to estimates for the cost of debt at various D/E levels. Her recent conversations with bankers led her to believe that the 7.75% rate was reasonable for levels not exceeding 25% D/V, but that for larger amounts of leverage the cost would be substantially greater. She just didn't know by how much.

As Hansson watched the snow fall, he knew he was in for a long night. He normally left detailed financial analyses to Dowling; however, this time he picked up the financial section of Gates' proposal (shown in **Exhibit 5**) as well as Dowling's cost of capital analysis, and began working on his own NPV estimates. He also planned to generate sensitivity analyses to see how changes in key project variables—especially capacity utilization, selling price per unit, and direct material cost per unit—would make the investment case stronger or weaker. It would be a long night and a long day tomorrow.

Exhibit 1: HPL's Historical Financial Statements

<i>Operating Results:</i>	2003	2004	2005	2006	2007
Revenue	\$503.4	\$543.7	\$587.2	\$636.1	\$680.7
Less: Cost of Goods Sold	<u>405.2</u>	<u>432.3</u>	<u>496.2</u>	<u>513.4</u>	<u>558.2</u>
Gross Profit	98.2	111.4	91.0	122.7	122.5
Less: Selling, General & Administrative	<u>37.8</u>	<u>44.6</u>	<u>45.8</u>	<u>51.5</u>	<u>49.0</u>
EBITDA	60.4	66.8	45.2	71.2	73.5
Less: Depreciation	<u>6.8</u>	<u>6.2</u>	<u>6.0</u>	<u>5.9</u>	<u>6.1</u>
EBIT	53.6	60.6	39.2	65.3	67.4
Less: Interest Expense	<u>5.5</u>	<u>5.8</u>	<u>5.9</u>	<u>5.3</u>	<u>3.3</u>
EBT	48.1	54.8	33.3	60.0	64.1
Less: Taxes	<u>19.2</u>	<u>22.0</u>	<u>13.3</u>	<u>24.0</u>	<u>25.6</u>
Net Income	\$28.9	\$32.8	\$20.0	\$36.0	\$38.5

Margins					
Revenue Growth	NA	8.0%	8.0%	8.3%	7.0%
Gross Margin	19.5%	20.5%	15.5%	19.3%	18.0%
Selling, General & Administrative/Revenue	7.5%	8.2%	7.8%	8.1%	7.2%
EBITDA Margin	12.0%	12.3%	7.7%	11.2%	10.8%
EBIT Margin	10.6%	11.1%	6.7%	10.3%	9.9%
Net Income Margin	5.7%	6.0%	3.4%	5.7%	5.7%
Effective Tax Rate	39.9%	40.1%	39.9%	40.0%	39.9%

<i>Assets:</i>	2003	2004	2005	2006	2007
Cash & Cash Equivalents	\$4.3	\$5.1	\$4.8	\$7.8	\$5.0
Accounts Receivable	62.1	70.1	78.8	87.1	93.3
Inventory	<u>57.7</u>	<u>58.0</u>	<u>61.2</u>	<u>61.9</u>	<u>67.3</u>
Total Current Assets	124.1	133.2	144.8	156.8	165.6
Property, Plant & Equipment	201.4	202.9	203.1	202.3	204.4
Other Non-Current Assets	<u>12.3</u>	<u>12.1</u>	<u>11.8</u>	<u>12.5</u>	<u>10.8</u>
Total Assets	\$337.8	\$348.2	\$359.7	\$371.6	\$380.8

<i>Liabilities & Owners' Equity:</i>	2003	2004	2005	2006	2007
Accounts Payable & Accrued Liabilities	\$42.2	\$45.0	\$51.6	\$53.4	\$58.1
Long-Term Debt	91.6	82.8	73.8	65.8	54.8
Owners' Equity	<u>204.0</u>	<u>220.4</u>	<u>234.3</u>	<u>252.4</u>	<u>267.9</u>
Total Liabilities & Owners' Equity	\$337.8	\$348.2	\$359.7	\$371.6	\$380.8

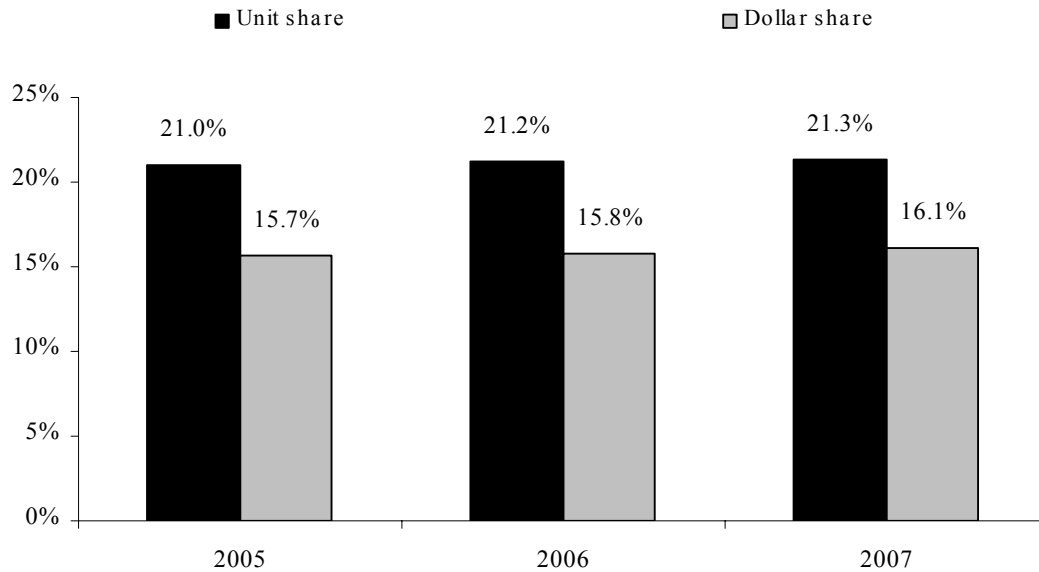
<i>Net Working Capital:</i>	2003	2004	2005	2006	2007
Accounts Receivable	62.1	70.1	78.8	87.1	93.3
Plus: Inventory	57.7	58.0	61.2	61.9	67.3
Less: Accounts Payable & Accrued Expenses	<u>42.2</u>	<u>45.0</u>	<u>51.6</u>	<u>53.4</u>	<u>58.1</u>
Net Working Capital	77.6	83.1	88.4	95.6	102.5

(Exhibit 1 cont'd next page)

Exhibit 1, cont'd

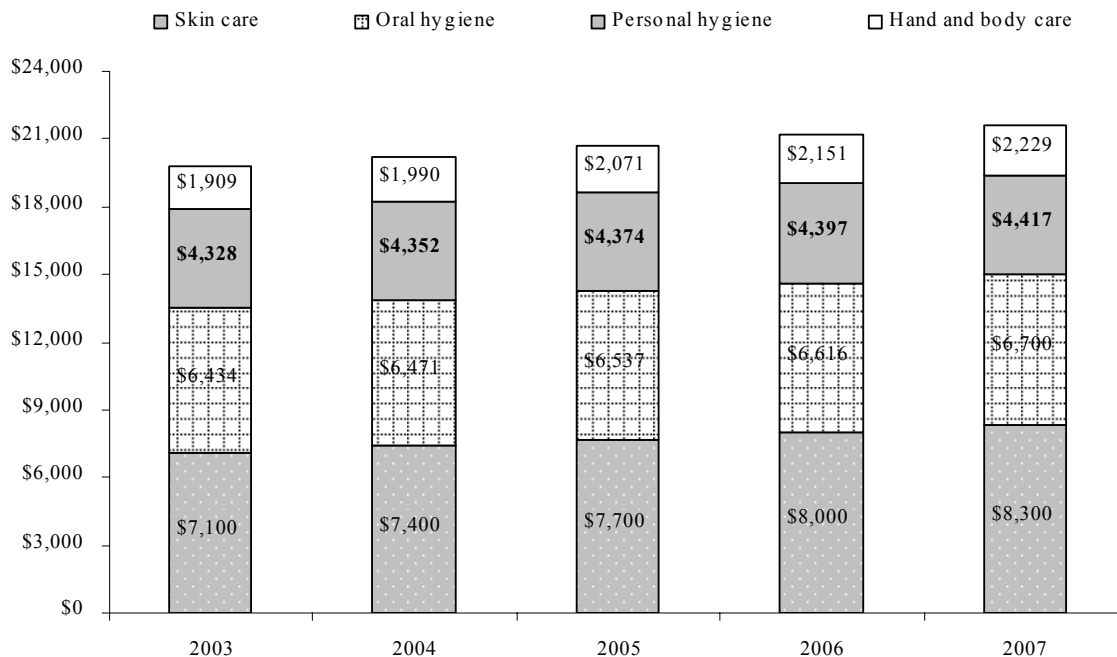
<u>Cash From Operations:</u>	2003	2004	2005	2006	2007
Net Income	\$28.9	\$32.8	\$20.0	\$36.0	\$38.5
Plus: Depreciation	6.8	6.2	6.0	5.9	6.1
Less: Increase in Accounts Receivable	3.1	8.0	8.7	8.3	6.2
Less: Increase in Inventory	0.5	0.3	3.2	0.7	5.4
Plus: Increase in Accounts Payable	<u>0.3</u>	<u>2.8</u>	<u>6.6</u>	<u>1.8</u>	<u>4.7</u>
Total Cash From Operations	\$32.4	\$33.5	\$20.7	\$34.7	\$37.7
 <u>Cash From Investing:</u>					
Capital Expenditures	\$7.3	\$7.7	\$6.2	\$5.1	\$8.2
Plus: Increases in Other Non-Current Assets	<u>0.5</u>	<u>(0.2)</u>	<u>(0.3)</u>	<u>0.7</u>	<u>(1.7)</u>
Total Cash Used in Investing	\$7.8	\$7.5	\$5.9	\$5.8	\$6.5
 <u>Cash From Financing:</u>					
Repayment of Debt	\$8.0	\$8.8	\$9.0	\$8.0	\$11.0
Plus: Dividend Payments	<u>14.4</u>	<u>16.4</u>	<u>6.1</u>	<u>17.9</u>	<u>23.0</u>
Cash Used in Financing	\$22.4	\$25.2	\$15.1	\$25.9	\$34.0
 Total Cash Generated	\$2.2	\$0.8	(\$0.3)	\$3.0	(\$2.8)

Exhibit 2: Private Label Share of U.S. Consumer Packaged-Goods Spending



Source: IRI

Exhibit 3: U.S. Sales in HPL's Target Markets (in US\$ millions)



Source: Datamonitor

Note: These figures include sales of both branded and private label products.

Exhibit 4: HPL's Sales into Its Retail Channels

Figures represent wholesale prices.

Channel	Sales (US\$ millions) for Year Ending December 31				
	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 ^a	31	33	34	37	40
Total	505	543	587	637	681

^a The category "All others" comprises convenience store sales and sales to miscellaneous distributors.

Exhibit 5: Excerpt of Financial Assumptions in Capital Request Form⁽¹⁾

<u>Revenue Projection:</u>		2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Capacity (000's)		80,000	80,000	80,000	80,000	80,000	80,000	80,000	80,000	80,000	80,000
Capacity Utilization		60.0%	65.0%	70.0%	75.0%	80.0%	85.0%	85.0%	85.0%	85.0%	85.0%
Unit Volume		48,000	52,000	56,000	60,000	64,000	68,000	68,000	68,000	68,000	68,000
Selling Price Per Unit - Growing at	2.0%	1.77	1.81	1.84	1.88	1.92	1.95	1.99	2.03	2.07	2.12
Revenue		84,960	93,881	103,124	112,700	122,618	132,887	135,545	138,256	141,021	143,841
<u>Production Costs:</u>											
Raw Materials Per Unit Growing at 1%	1.0%	0.94	0.95	0.96	0.97	0.98	0.99	1.00	1.01	1.02	1.03
Manufacturing Overhead Growing at	3.0%	3,600	3,708	3,819	3,934	4,052	4,173	4,299	4,428	4,560	4,697
Maintenance Expense Growing at	3.0%	2,250	2,318	2,387	2,459	2,532	2,608	2,687	2,767	2,850	2,936
<u>Salaried Labor Cost:</u>											
Managers		4	4	6	6	8	8	8	8	8	8
Average Annual Fully Loaded Cost	3.5%	160.0	165.6	171.4	177.4	183.6	190.0	196.7	203.6	210.7	218.1
Total Salaried Labor Cost		640.0	662.4	1,028.4	1,064.4	1,468.8	1,520.2	1,573.4	1,628.5	1,685.5	1,744.5
<u>Hourly Labor Cost:</u>											
Average Fully Loaded Hourly Cost	3.5%	20.00	20.70	21.42	22.17	22.95	23.75	24.59	25.45	26.34	27.26
Hours Per Year		2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000	2,000
Cost Per Hourly Employee		40,000	41,400	42,849	44,349	45,901	47,507	49,170	50,891	52,672	54,516
Number of Hourly Workers		450	473	509	545	582	618	618	618	618	618
Total Hourly Labor Cost (000's)		18,000.0	19,570.9	21,814.0	24,190.2	26,706.0	29,368.2	30,396.1	31,460.0	32,561.1	33,700.7
Total Labor Cost		18,640.0	20,233.3	22,842.4	25,254.6	28,174.8	30,888.5	31,969.6	33,088.5	34,246.6	35,445.2
Selling, General & Administrative/Revenue		7.8%	7.8%	7.8%	7.8%	7.8%	7.8%	7.8%	7.8%	7.8%	7.8%
<u>Working Capital Assumptions:(2)</u>											
Days Sales Outstanding		47.6x	47.6x	47.6x	47.6x	47.6x	47.6x	47.6x	47.6x	47.6x	47.6x
Days Sales Inventory		37.6x	37.6x	37.6x	37.6x	37.6x	37.6x	37.6x	37.6x	37.6x	37.6x
Days Payable Outstanding		34.2x	34.2x	34.2x	34.2x	34.2x	34.2x	34.2x	34.2x	34.2x	34.2x

(1) Note that accounts receivable less accounts payable will be returned at the end of the project. Also note that all working capital ratios are based on a 360 day year.

(2) Based on historical averages.

Exhibit 6: Comparable Company Analysis

<u>Company:</u>	Market Value	Net Debt	Enterprise Value	Equity Beta	Revenue	EBITDA	EBIT	Net Income	Book Value
Cathleen Sinclair	298.9	1,329.6	1,628.5	2.22	1,346.8	255.3	163.4	21.5	(1,112.8)
General Health & Beauty	319.3	63.1	382.4	1.95	446.1	61.9	51.9	23.8	204.2
Women's Care Company	498.6	55.3	553.9	1.14	397.3	52.7	49.3	77.0	43.7
Skin Care Enterprises	1,204.2	371.9	1,576.1	1.35	1,247.6	155.8	125.4	65.3	316.2

<u>Company:</u>	EBITDA	EBIT	Earnings	Revenue	EBITDA	EBIT	P/E	P/B
Cathleen Sinclair	19.0%	12.1%	1.6%	1.2x	6.4x	10.0x	13.9x	NM
General Health & Beauty	13.9%	11.6%	5.3%	0.9x	6.2x	7.4x	13.4x	1.6x
Women's Care Company	13.3%	12.4%	19.4%	1.4x	10.5x	11.2x	6.5x	11.4x
Skin Care Enterprises	<u>12.5%</u>	<u>10.1%</u>	<u>5.2%</u>	<u>1.3x</u>	<u>10.1x</u>	<u>12.6x</u>	<u>18.4x</u>	<u>3.8x</u>
Average	14.6%	11.6%	7.9%	1.2x	8.3x	10.3x	13.1x	5.6x

Exhibit 7: Cost of Capital Analysis

Company:

Cathleen Sinclair

General Health & Beauty

Women's Care Company

Skin Care Enterprises

Average

Debt/ Value	Debt/ Equity	Equity Beta	Debt Beta	Asset Beta
81.6%	444.9%	2.22	0.25	0.79
16.5%	19.8%	1.95	0.00	1.74
10.0%	11.1%	1.14	0.00	1.07
<u>23.6%</u>	<u>30.9%</u>	<u>1.35</u>	<u>0.00</u>	<u>1.14</u>
32.9%	49.1%	1.67	0.06	1.18

Debt/ Value	Debt/ Equity	Asset Beta	Equity Beta	Cost of Equity	Cost of Debt	WACC
0.0%	0.0%	1.18	1.18	9.67%	7.75%	9.67%
5.0%	5.3%	1.18	1.22	9.86%	7.75%	9.60%
10.0%	11.1%	1.18	1.26	10.07%	7.75%	9.53%
15.0%	17.6%	1.18	1.31	10.30%	7.75%	9.45%
20.0%	25.0%	1.18	1.36	10.56%	7.75%	9.38%
25.0%	33.3%	1.18	1.42	10.86%	7.75%	9.31%

Assumptions:

10-Year Treasury	3.75%
Market Risk Premium	5.00%
Tax Rate	40.0%
Est. Hansson EBITDA Multiple	7.0x
Est. Hansson Enterprise Value	514.5
Existing Net Debt	49.8
Plus: New Expansion Debt	<u>57.8</u>
Total Estimated Debt	107.6
Existing D/V	9.7%
Estimated New D/V	20.9%
Assumed Debt Beta	0.00
Estimated Cost of Debt	7.75%