Products capital structure case study

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American Home Products is a corporation involved in the production and marketing of over 1, 500 consumer goods allocated among four distinct lines of business comprised of prescription drugs, packaged drugs, foodproducts, housewares and household products. While the corporation does not invest heavily into the research and development of new lines of business, its success is a result of its ability to aggressively market the products it manufactures, especially the company's line of prescriptin drugs.

American Home Products is a company with virtually no debt and an impressive amount of cash on its balance sheet. Under its currentleadership, CEO William F. Laporte maintains an extremely conservative capital structure. During his 17 year tenure, Laporte's brand of centralized micro-management created a company with a clean, low-debt balance sheet; cash reserves equal to 40% of its net worth (Total Assets less Total Liabilities); sales in excess of $4 billion with growth ranging between 10%-15% annually; and remarkable gains in market share while reducing or maintaining a low level of expenses. All this combined with dividend growth of 222% between 1972 - 1981, contributed to the firm's AAA bond rating and to the popularity of AHP's stock among retail and, primarily, institutional investors. Laporte was repeatedly quoted to say, " We run this company for the shareholders."

We are asked to analyze the company's debt policy and its current capital structure. There after, we are to make a recommendation to the CEO regarding modifications to its debt ratio or portion of capital contributed by debt so that the firm can affect a repurchase of a portion of its outstanding stock. The options available for selection are a preserved debt ratio of 30% or increased debt ratios of 50% and 70%. It is likely that adding debt to the capital structure would create some value for shareholders; however, Laporte is firmly against borrowing and is extremely risk-averse.

In general, the lower the company's reliance on debt for asset formation, the less risky the company is since excessive debt can lead to a very heavy interest and principal repayment burden. This is demonstrated through statistics such as high financial risk, low interest coverage ratios, and high debt ratios. However, when a company chooses to forgo debt and rely largely on equity, as in the case of AHP, the company does so at the expense of a tax reduction effect supplied by interest payments. Thus, a company has to consider both risk and tax issues when deciding on an optimal debt ratio.

Recommendation After reviewing the disclosed information, we believe that AHP and its shareholders are best served by maintaining a debt ratio of 30% and using a portion of cash reserves to repurchase outstanding AHP stock. Given Mr. Laporte's unique brand of management and company control, we believe that the primary argument for maintaining a 30% debt ratio is the threat of corporate takeover via a leveraged buyout.

A method of corporate takeover or merger popularized in the 1980s, leveraged buyouts involved the purchase of controlling interest in a company's corporate stock with a substantial fraction of borrowed funds financed with the takeover company's assets. These takeovers were heavily leveraged in that the acquiring group used very little of their ownmoneyand borrowed the rest, often by issuing extremely risky, but high interest bonds (AKA Junk Bonds). These bonds were high-risk, and thus paid a high interest rate, because little or nothing backed them up. Companies during this period that were most susceptible to the LBO specter were those that were extremely cash-rich.

After the takeover, the acquiring group could utilize the cash of the acquired company to either meet the interest payments of the high interest bonds or retire the bonds completely. Maintaining the 30% debt ratio allows the CEO to sustain tight control while avoiding the threat of a LBO. AHP could also leverage its strong balance sheet to borrow along other methods in order to execute a stock repurchase.

While AHP certainly possesses the ability to meet additional debt obligations and interest payments, we would continue to argue against greater debt because with added securities outstanding, the possibility of an LBO increases during the high interest rateenvironmentof the 1980s. Additionally, the company's financing needs outside of cash to repurchase outstanding stock is not great considering that AHP does not launch new products until a product has been proven successful in the market.

We also would avoid a higher debt ratio from a personal perspective. Due to Mr. Laporte's conservative nature, we do not believe that he would welcome the recommendation of a drastic change to the company's capital structure - a move defined by an increase from 30% to 50 - 70% debt. Needlessly recommending higher leverage for greater tax savings in a company that already has tight expense control is illogical. Mr. Laporte or his replacement would surely terminate a business relationship with advisors that make such a recommendation.

Business / Financial Risk AHP's operating strategy is risk averse. As it is operating in a high interest rate environment, the issuance of debt could be cause for greater business risk and the need for increased revenue generation to meet greater interest payments. Inherent to any security is the quantifiable likelihood of loss or less-than-expected returns. The firm's business risk is associated with the unique circumstances that affect an industry in which the business operates, as they might affect the price of that company's securities and the firm's performance. For example, an event that would negatively affect the entire pharmaceuticals industry would pose a business risk to AHP since it operates within that framework.

A capital structure comprised of 30% debt should not have a great effect on AHP's business risk statistic. In fact, the implications of a 30% debt strategy could actually reduce AHP's business risk, while marginally increasing the firm's financial risk. Less debt makes AHP less reliant on the need for growing revenues or sales, because of its lack of financial obligations. The firm's financial risk is the possibility that it could potentially default on its debt by failing to repay principal and interest in a timely manner. From Exhibit 1, it is evident that AHP does not run the risk of presenting a low interest coverage ratio (EBIT divided by interest payments) or a low ratio of cash flows available to pay for debt. Again, a lower percentage of debt reduces this risk and the default outcome.

Leverage: Good or Bad? In most cases, a corporation's capital structure is comprised of both equity and debt. Debt is utilized for its tax savings ability in that the firm's interest payments to holders of its debt are a reduction from profit before tax. The less profit before tax, the less tax paid by the corporation. If AHP were to issue more debt in order tofinancethe repurchase of outstanding stock, it would maximize shareholder EPS (earnings/outstanding stock) because of the fewer shares outstanding. However, there would also be less profit after tax due to the higher interest payments required with each greater level of debt.

In the end, the remaining outstanding shares may not be any better off because the firm would then have theresponsibilityof making greater interest payments. However, the potential value at 30% is presented with consistent lower interest payments, less variability in required sales, greater profit before tax, as well as more impressive financial ratios and firm net worth. Higher debt ratios at 50 or 70% include greater interest expenses with tax savings, but they also increase the firm's financial risk and to a degree, business risk too. We do not believe that it is a reasonable trade-off. If AHP were financing advances in R; D or product development to increase business operations, we would recommend a greater reliance on debt in order to increase the firm's access to sources of capital. However, this is not the case.

What will the capital markets say? Given that our recommendation does not greatly deviate from the current capital structure, we do not anticipate a change in the company's debt rating or share price. Furthermore, management's style of leadership is not jeapordized with the recommended lower portion of debt because it follows the company's historical capital structure.