

Hershey's: bitter times in a sweet place essay



**ASSIGN
BUSTER**

HERSHEY FOODS CORPORATION: BITTER TIMES IN A SWEET PLACE

INTRODUCTION Born into a poor, lower-class family, Milton S. Hershey dropped out of school before reaching the fourth grade. He developed an interest in becoming a confectioner. He believed there would be great demand for affordable, mass-produced chocolate, and thus he built the Hershey Chocolate Company. Hershey's is now the largest producer of quality chocolates in North America and a global leader in chocolate and sugar confectionery. Although he enjoyed making money, Milton S.

Hershey was intent on using his vast fortune for philanthropic purposes. He decided to surround his enterprise with a model town and personally financed the building of roads, utilities, houses, and public buildings. In addition, he and his wife donated their whole fortune to create the Milton Hershey School. The Hershey Trust Company was created to manage the founder's large endowment. Additionally, the Hershey Trust Company's board of trustees was given the principal objective to financially support the mission of the Milton Hershey School.

By 2002, the Hershey Trust Company became Hershey Foods Corporation's largest shareholder, owning 77% of the stockholders' votes. In March of 2002, the Hershey Trust Company's board of trustees decided to sell the shares it held in the Hershey Foods Corporation with the belief that it would be better to diversify its holdings and not concentrate the bulk of its investments in Hershey stock. The Hershey Trust Company board of trustees considered two offers: a \$12.5 billion dollar bid from the Wm. Wrigley Jr. Company; and a \$10.5 billion dollar joint bid from Nestle S. A. and Cadbury Schweppes PLC.

Hershey Foods Corporation, its employees, the community of Hershey, Pennsylvania, and the Attorney General of the state of Pennsylvania were adamantly opposed to this sale. CONCLUSIONS We favor the rejection of Wrigley's offer as well as that of Nestle S. A. /Cadbury Schweppes PLC because we do not believe that the board of trustees of the Hershey Trust Company made a convincing argument in favor of financial diversification. First, we do not believe the Hershey Trust Company was in serious financial jeopardy even with their largest investment in the Hershey Foods Company.

Secondly, diversifying their investment portfolio may make the Hershey Trust Company subject to greater economic risk. In addition, we believe that neither bidding party (Wm. Wrigley's or Nestle S. A. /Cadbury Schweppes PLC) have a vested interest in protecting the philanthropic, charitable, and socially responsible legacy of the founder, Milton S. Hershey. The new owner may agree in principle to uphold the founder's legacy, but what if either of these parties was purchased by a larger multinational company? Or, what if either of these parties eventually became bankrupt?

In our analysis, there is no contractual obligation that will prevent either of these two parties from selling Hershey Food Corporation's assets and ignoring the philanthropic legacy of its founder should any of these adverse economic situations occur. Moreover, after analyzing the financial statements of the Hershey Foods Corporation, we found that they are financially sound and will remain so into the foreseeable future. Therefore, a sale of the Hershey Trust Company's shares of Hershey Foods Corporation stock is not a financially advisable decision that our group can support at this time.

Assume that you are a member of the Hershey Trust board. To whom (or what) do you owe your fiduciary responsibility? How does the legacy of Milton S. Hershey affect your thinking as a member of the board? If we were members on the Hershey Trust Company board, we would owe our fiduciary responsibility primarily to the Milton Hershey School and to financially support the mission of the institution. The legacy of Milton S. Hershey would affect our thinking as members of the board in the sense that we know Mr. Hershey dedicated his life to helping others in his community.

The idea of educating disadvantaged children was extremely important to him, especially since he had no children of his own and it was his late wife's idea. This legacy of educating disadvantaged children from the community would affect our thinking as members of the Hershey Trust Company's board of trustees. It may be viewed as a bias in our decision-making where we may favor protecting the endowment of the Milton Hershey School over protecting the equally important interests of the Hershey Foods Corporation and the Hershey, Pennsylvania community in general.

Is diversification a valid reason to sell HFC? How would such diversification have served the Hershey School 10 years ago, for example? What are the pros and cons of this strategy? We believe that diversification of an investment portfolio alone is not a valid reason to sell Hershey Foods Corporation in this case. Ten years ago, there would have been few benefits for the Hershey School with the sale of the Hershey Foods Corporation stock. These benefits include a price advantage on the sale of the stock and a short-term monetary gain for the endowment fund.

Another benefit is that the Hershey Trust Company's investment portfolio would be less concentrated in Hershey stock, which in theory may be to their advantage if the Hershey stock were to suddenly decline in value. Ten years ago the Hershey Trust Company, who was a major shareholder in the Hershey Corporation, was advised that in order to ensure adequate funding for the Milton Hershey School a diversification of their assets would be necessary. In theory, diversification of an investment portfolio is a commonly acceptable practice to help minimize risk. However, can we ever imagine a circumstance in which diversification may be detrimental?

Our analysis reveals that in this particular case, diversification is indeed detrimental for several reasons. Case in point, the Hershey Trust Company owned close to 77% of the controlling stake in the Hershey Foods Corporation. When the board of trustees of the Hershey Trust Company first approached Hershey Foods Corporation CEO Richard Lenny, he opposed the idea of selling and proposed several alternative solutions for the board to consider. Determined that selling was their best option available, the Hershey Trust Company informed Richard Lenny that they were going through with the sale.

Investment diversification is advisable only if it is likely to have a beneficial impact for all existing stakeholders. In this unique case, the only stakeholders that we foresee could have benefitted from this sale would have been the Hershey Trust Company and the eventual new owner of Hershey Foods Corporation. The Hershey Foods Corporation, its employees, and the community of Hershey, Pennsylvania would not have profited substantially from the sale. In 2002, the Hershey Foods Corporation stock

represented more than 50% of the Hershey Trust's \$5. billion dollar endowment fund. The Hershey Trust Company's board of trustees could have pursued diversification by selling only a portion of its Hershey holdings, but the board realized that selling their entire ownership in Hershey Foods Corporation would bring a significant price advantage. Focused exclusively on their fiduciary responsibility to maximize the Trust's fund to benefit the Milton Hershey School, the board members decided to sell the Hershey Foods Corporation stock in its entirety, with the hopes of realizing the largest possible profit.

A spokesman for the Hershey Foods Corporation stated their board would be willing to buy back a substantial amount of shares from the Hershey Trust Company. The Hershey Foods Corporation was willing to buy back as much as \$500 million in common stock. This transaction was supposed to take about a year to complete. The Hershey Foods Corporation would eventually be willing to buy back approximately \$7. 55 billion in stock from the Hershey Trust Company. Which, if any, bid would you vote to accept for the purchase of Hershey Foods Corporation?

Is your decision primarily based on the economics of the bids or the desire to honor the legacy of Milton S. Hershey? The group does need to come to a "final" decision or recommendation with respect to this, but I expect that you will present different points of view in your write-up. The Wm. Wrigley Jr. bid included \$12. 5 billion (\$7. 5 billion in stock and \$5. 0 billion in cash) for the 100% outstanding shares. The offer was equivalent to \$89 per share. Also, the Hershey Trust Company was going to get shares in the new company named Wrigley-Hershey. Besides the economic offers, Wm. Wrigley Jr.

ncluded in the deal their commitment to the Hershey community that included job retention at Hershey's plants. On the other hand, the joint bid by Nestle S. A. and Cadbury Schweppes PLC was \$10. 5 billion in cash at \$75 per share. This deal included the proposal that Hershey, Pennsylvania was going to be the headquarters of Cadbury Schweppes PLC in the United States, and it was going to be named " The Chocolate Capital of the World. " If the Hershey Trust board wanted to honor the legacy of Milton S. Hershey, they should accept the bid from Wm. Wrigley Jr. Their offer was financially more attractive.

The price per share offered was 42% premium over Hershey's preannouncement stock price. With the exchange of shares, Wm. Wrigley Jr. 's plan was to create a new company named Wrigley-Hershey. Additionally, the offer proposed their commitment to the community and the Hershey employees. Since the other bid was a joint bid by Nestle S. A. and Cadbury Schweppes PLC, the division of the company was going to lead to the possible disappearance of the Hershey Foods Company as we know it. Therefore, if the Hershey Trust board's main interest was their founder's legacy, the best option was the bid of Wm. Wrigley Jr.

Alternatively, if the Hershey Trust board was primarily based on economics, the board should accept the joint bid from Nestle S. A. and Cadbury Schweppes PLC. Although their offer per share was not as high as the bid from Wm. Wrigley Jr. , Nestle S. A. and Cadbury Schweppes PLC are both strong multinational companies that are very well positioned around the world. Both companies have experience in the confectionery and beverage industries. Both companies have achieved a history of successful acquisitions

and have been able take advantage of the mergers to consolidate themselves as leading companies in their respective industries.

They also have the distribution network necessary to introduce Hershey products into new markets. Finally, their combined experience in the confectionery industry will allow them to better manage Hershey's products and manufacturing which will ultimately lead to economic benefits for its shareholders. However, after analyzing both bids, our decision is to reject both offers. Hershey Foods Corporation is performing strongly in the confectionery industry. In 2001, Hershey led the US market with 30% market share.

The average stock returns for Hershey Foods Corporation, according to Standard & Poor's, have been higher than the benchmark for the S&P 500. During a five-year average, from 1997 to 2001, Hershey had a mean of 16.4% compared to a 9.0% from the S&P 500. In a sixteen-year comparison, Hershey's average stock return was 18.8% relative to a 12.0% return for the S&P 500. According to Moody's Investor Service, Hershey's A+ rating is supported by its solid liquidity, stable cash flows, moderate leverage, and the company's leading position in the U. S. confectionery industry.

Furthermore, Moody's explained that retained cash flow to debt exceeds 45%, with EBIT/Interest of over 10x. Hershey's strong market position affords the company considerable earnings stability and reduces the volatility of its operating performance. Hershey Foods Corporation is not a multinational company as is Nestle S. A. or Cadbury Schweppes PLC; however, Hershey Foods Corporation has been able to position their products in global markets.

Hershey's products are sold in more than 60 different countries. Hershey's brand name is an American icon and one of the oldest chocolate companies in the United States.

With the news of selling Hershey Foods Corporation, there was also community involvement to protest the sale of a company that has supported an entire community for over a hundred years. If you decided to reject both bids and not sell HFC, what will you do to achieve the diversification objective? If you decided to accept one of the bids, what (if anything) would you want to communicate to the constituents who opposed the sale? It is our opinion that another option must be pursued to achieve the Hershey Trust Company's goal of investment diversification.

This option must be pursued without selling a profitable company that has allowed the Milton Hershey School's endowment fund to grow substantially through the years. The endowment fund's size and continuous growth is almost directly attributed to the sound financial performance of the Hershey Foods Corporation. Furthermore, the philanthropic and charitable mission of Milton S. Hershey himself was made possible by the financial success of the Hershey Foods Corporation. With this in mind, we propose that the Hershey Trust Company agree to a mutually acceptable, long-term (5-10 year) stock buy-back program with the Hershey Foods Corporation.

As initially proposed by Hershey Foods Corporation CEO Richard Lenny, this deal would allow for an initial year one buy-back of \$500 million worth of common stock. This graduated buy-back approach would need to be mutually acceptable for both the Hershey Trust Company and Hershey Foods

Corporation. Hershey Foods Corporation must take into consideration how much they are able to expend from their retained earnings to fund this buy-back program without leaving them financially vulnerable. In addition, the Hershey Trust Company must determine to what level they are willing to draw down their investment in Hershey Foods Corporation.

However, we feel that Hershey Trust Company must maintain a minimum investment of 10% of their portfolio allocated to Hershey Foods Corporation stock. We believe this graduated stock buy-back approach will protect the interests of both the Hershey Trust Company and Hershey Foods Corporation.

ANALYSIS Hershey's Income Statement Analysis: Leverage Ratios • TIE (Times Interest Earned) Ratio = Operating Income / Interest expense • TIE ratios about 12x to 6x from 1996-2001 • Cash Coverage Ratio = (EBIT + Depreciation) / Interest Expense • CC ratio is about 11x to 6x from 1996-2001 • Conclusion: Hershey Foods Corp. annual income/earning were able to cover its interest obligations 11x to 6x (financial charges associated with this use of financial leverage). EPS (Earning Per Share) = Net Income / Common Shares Outstanding • In 1996-1999, Hershey's EPS increases from 2.04 to 3.44 (51% increase in 3 years) • In 1999-2001, Hershey's EPS drops from 3.44 to 1.55 (76% decrease in 2 years!) • Conclusion: 76% drop of EPS from 1999-2001 is probably the primary reason that the Hershey Trust board desired to sell HSY in 2001/2002. Beta (Exhibit 8) Hershey: 0.55 Wrigley: 0.7 Nestle: 0.7 Cadbury Schweppes: 0.6 Interpretation: Beta ; 1, investment is less risky than the market (Chapter 6) • Hershey's is less risky than the bidding companies. • Therefore, accepting either bid will increase the risk of the portfolio of Hershey Trust board. Hershey's Financial

Statement Analysis by Ratio: Liquidity Ratios: Measures the ability of

Hershey's to meet its short-term financial obligations. • Current Ratio:

According to our analysis, we found that the current ratio equals 1.93x. Any

current ratio of greater than one indicates there is a sufficient amount of

current assets in Hershey's to pay off its current liabilities. Quick Ratio:

According to our analysis, we found that the quick ratio equals 1.08x. Any

quick ratio of greater than one means that Hershey's is able to repay current

liabilities with its most liquid assets. Leverage Ratios: • Debt Ratio:

According to our analysis, the debt ratio equals 0.65x. A debt ratio less than

one indicates that a company has more assets than debt. From 1997-2002,

the proportion of Hershey's assets financed with debt decreased by 9%.

Hershey's is in a better position according to the debt ratio analysis because

the lower the debt ratio, the lower the financial risk. Debt-To-Equity Ratio

(D/E): According to our analysis, the debt-to-equity ratio equals 1.83x. A

ratio greater than one means assets are mainly financed with debt. However,

the ratio decreased by 1.03% from 1997-2002 indicating that the relative

proportion of shareholders' equity and debt used to finance a company's

assets decreased. Profitability Ratio: • Profitability Ratio in Relation to Sales:

Measures Hershey's ability to convert sales volume into bottom line profit. •

Net Profit Margin: Indicates Hershey's amount of net profit for each dollar of

sales.

By analyzing the graph, we can see that in the past three years, Hershey's

net profit margin has dropped by 7%. This indicates that Hershey's has not

been effective lately at producing and selling products well above cost. •

Profitability Ratio in Relation to Investment: This profitability ratio relates

profits to investment. • Return on Assets Ratio: The average ROA from 1996 to 2001 was 9.8%. In 2001, ROA was lower than average at 6.4%. Even though 2001 was not a good year for assets to generate earnings, Hershey's still had a high and steady ROA throughout the six years analyzed. 2001 was the only year in which the ROA percentage was below 9%. This indicates that Hershey's has invested effectively to produce a sizable net income. • Return on Equity Ratio: It calculates Hershey's ability to convert investment into profit. ROE's between 15% and 20% are desirable and it is calculated by dividing net income by common equity. In 2001, Hershey's ROE was 18.05% lower compared to the 6-year average of 30.68%. Although it is lower than the average, Hershey's has been able to maintain a solid ROE through the years. Only 2001 recorded an ROE below 20%. Finally, there may be a number of reasons why ROE in 2001.

This figure may be attributed to the buy-back of common shares. Also a sluggish economy in 2001 was an additional reason for the lower ROE. However, Hershey's has been using their investment funds successfully to generate earnings growth throughout the years. Efficiency Ratios (Asset Utilization): • Receivables Turnover Ratio: The ratio was calculated from 1996-2001. The average of those six years was 11.52x. In 2001, the ratio was 11.44x. Hershey's is collecting the accounts receivables on average eleven times their sales. Therefore, it shows that Hershey's is efficient in the collection process and the extent of credit. Average Collection Period: The ratio was calculated from 1996-2001. The average was 32 days. The figure in the year 2001 was 32 days which was a six-day improvement over previous years. Overall, Hershey's has been consistent in the collecting period

through the six years analyzed. Consequently, Hershey's shows to be very effective throughout the years to collect the credit sales. The credit sales are collected in approximately one month. • Inventory Turnover Ratio: In 2001, the ratio was 5.21x which is .9 % higher compared to the average of 4.72x. Hershey's has had a steady inventory turnover ratio throughout the years analyzed.

It denotes that Hershey is able to turn its inventory on average 4.72x its sales which equates to high and steady sales. • Fixed Asset Turnover Ratio: In 2001 this ratio was better. It was 2.70x compared to the average of the last six years (2.63x). It represents that Hershey's is effectively using their investment in fix assets to generate revenue. • Total Asset Turnover Ratio: In 2001, Hershey's ratio was 1.27x compared to the average of 1.26x. As mentioned in previous ratios, Hershey's has had a stable ratio during the past six years.

Two Bids on Hershey Foods Corporation (2002): Based on Exhibit 10 Pro Forma Financial Statement of Hershey Foods Corporation (2002-2011) | Co. | Wm. Wrigley Jr. | Nestle-Cadbury Schweppes | | Year | Cash flow X (in \$ millions) | Cash flow Y (in \$ millions) | | 2001 | I. O. = - 11352.8 | -9352.8 | | 2002 | 386.3 | 386.3 | | 2003 | 433.2 | 433. | | 2004 | 483.9 | 483.9 | | 2005 | 508.1 | 508.1 | | 2006 | 533.5 | 533.5 | | 2007 | 560.1 | 560.1 | | 2008 | 588.1 | 588. | | 2009 | 617.5 | 617.5 | | 2010 | 648.4 | 648.4 | | 2011 | 680.9 | 680.9 | I. O. (Wm. Wrigley's bid) = 12500 - [Book Value of Hershey (1147.2), Ex 9] = 11352.8 I. O. (Nestle-Cadbury Schweppes bid) = 10500 - (1147.2) = 9352.8

Market required rate of return (using the average 10-year historical yield of U. S. Treasuries): • Exhibit 8 (4.28% + 3.82%) / 2 = 4.05% NPV (X) = -

Interpretation: • Negative NPV for both bids – Both bids will not recover their investments of acquiring Hershey's in 10 years. • Therefore, both bids offer above market/fair value of Hershey's. • Wm. Wrigley Jr. bid (\$12.5 billion) is more attractive from financial point of view (NPV = 7033.27). NPV values are confirmed from IRR and PB values. • The Hershey Trust board must

Foods Corporation (\$ millions)	Income Statement Analysis (EX 9)										Year	
	1996	1997	1998	1999	2000	2001	Remark					
Sales	3989.0	4302.2	4435.6	3970.9	4221.0	4137.2		COGS	2302.1	2488.9	2625.1	
Gross Profit	2354.7	2471.2	2668.5						1687.2	1813.3	1810.6	
Operating Income	1616.2	1749.8	1468.7						563.0	630.2		
Interest expense	642.8	558.4	622.7	412.6					48.0	76.3	85.7	
TIE Ratio	74.3	76.0	69.1						11.73x	8.26x	7.50x	7.52x
EBIT	5.97x								527.0	630.2	642.8	802.1
Cash Coverage Ratio									622.7	412.6		
Net income									273.0	336.3	341.0	460.3

Common Shares	134	134	134	134	134	134	EX 11		EPS	2. 04	2.
	51	2. 54	3. 44	2. 50	1. 55		APPENDIX B	Year	1996	1997	1998
	1999	2000	2001	Average		Net Income (NI)	273. 0	336. 30	341. 00		
	460. 30	334. 50	207. 10		Total Assets	3184. 80	3291. 20	3404. 10			
	3346. 70	3447. 80	3247. 40		ROA: NI/Total Assets	0. 08578247	0.				
	10218158	0. 10017332	0. 13753847	0. 09701839	0. 0637741						8.
	6%	10. 2%	10. 0%	13. 8%	9. 7%	6. 4%	9. %				Efficiency

Ratios								Receivables Turnover Ratio: Sales/Accounts Receivable		
								Fixed Asset Turnover Ratio: Sales/Net Fixed Assets		
								Average Collection Period: Accounts Receivable/Daily Credit Sales		
								Total Asset Turnover Ratio: Sales/Total Assets		
								Inventory Turnover Ratio: Cost of Goods Sold/Inventory		
								Year		1996
										1997
										1998
										1999
										2000
										2001
								Average		
								Sales		3989.30
										4302.02
										4435.60
										3970.90
										4221.00
										4137.20
										COGS
										2302.10
										2488.90
										2625.10
										2354.70
										2471.20
										2668.50
										Account Receivable
										294.60
										360.80
										451.30
										352.80
										379.70
										361.70
										Inventory
										475.00
										505.50
										493.20
										602.20
										605.20
										512.10
										Net Fixed Assets
										1601.90
										1648.20
										1648.0
										1510.50
										1585.40
										1534.90
										Total Assets
										3184.80
										3291.20
										3404.10
										3346.70
										3447.80
										3247.40
										Receivables Turnover Ratio
										13.54
										14.12
										11.92
										35.58
										8.82
										49.54
										6.46
										11.25
										53.85
										5.11
										25.38
										55.11
										11.66
										7.11
										11.43
										8.20
										85.08
										5.54
										26.32
										87.19
										5.32
										25.87
										19.74
										4.08
										32.78
										26.63
										1.27
										4.85
										4.92
										5.32
										3.91
										4.08
										5.21
										4.72
										Fixed Asset Turnover Ratio
										2.49
										03.55
										2.27
										61.32
										2.69
										13.15
										2.62
										86.46
										2.66
										24.19
										58.26
										2.69
										54.19
										99.26
										2.49
										2.61
										2.69
										2.63
										2.66
										2.70
										2.63
										Average Collection Period
										26.95
										43.52
										29.91
										35.29
										30.11
										66.61
										37.13
										69.15
										32.42
										89.20
										4.32
										83.57
										70.23
										31.91
										05.91
										17.26
										95.95
										43.26
										91.30
										14.37
										43.32
										83.32
										57.02
										31.91
										05.91
										17.26
										95.95
										43.26
										91.30
										14.37
										43.32
										83.32
										57.02
										31.91
										05.91
										17.26
										95.95
										43.26
										91.30
										14.37
										43.32
										83.32
										57.02
										31.91
										05.91
										17.26
										95.95
										43.26
										91.30
										14.37
										43.32
										83.32
										57.02
										31.91
										05.91
										17.26
										95.95
										43.26
										91.30
										14.37
										43.32
										83.32
										57.02
										31.91
										05.91
										17.26
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										83.32
										57.02
										31.91