

# The capital structure choice of pepsi



The collection of securities that the firm issues to raise capital from investors is the firm's capital structure. Equity and debt are the most commonly used securities by firms. The amount of debt determines the firm's leverage. The firm should always use a capital structure which will maximize the total value of the securities issued.

In order to determine the capital structure of a firm, It is also necessary to determine the different ratios such as net debt ratio, fixed coverage ratio, interest ratio, long term debt ratio, cash flow ratio, etc, to evaluate the effects of the ratios on the on the firm. These ratios are useful for comparing & analyzing with other competitor firms. Ratios help the firm to determine their position in terms of the market value, book value, market capitalization, debt value, revenues, etc.

The Modigliani-Miller theorem states that, the firm's value is unaffected by the way it is financed in the absence of taxes, bankruptcy costs and asymmetric information in a perfect market. It does not matter if the firm's capital is raised by issuing stock or by selling debt. It does not matter what the firm's dividend policy is. Therefore, the Modigliani-Miller theorem is also often called the capital structure irrelevance principle. We will look at this theory in detail in capital structure.

In this report we look at the different theories (pecking order theory, trade-off theory, asset substitution theory, modigliani-miller theory) capital structure choice of PepsiCo by determining various ratios, comparing PepsiCo with its competitors. Analysis of the results and recommendations provided.

## **INTRODUCTION**

Pepsi was originally named as “Brad’s Drink”, after its creator, Caleb Bradham, a pharmacist from New Bern, North Carolina. Pepsi was created in 1893 and was later renamed as Pepsi Cola in 1898. Pepsi contained the digestive enzymes pepsin and kola nuts used in manufacturing Pepsi. Bradham had thought about creating a drink for people that was delicious and would help in digestion and boost energy.

PepsiCo Inc. is an American Multinational Corporation headquartered in New York. The company manufactures markets & sells a range of salty sweet & grain based snacks. It also produces carbonated & non-carbonated beverages and other food products. PepsiCo has approximately 285, 000 employees working in over 200 countries.

Pepsi Cola Company began in 1898, but it only became known as PepsiCo when it merged with Frito Lays in 1965. Until 1997 it also owned KFC, Pizza Hut and Taco Bell. In 1998 & 2001 PepsiCo bought Tropicana & Quaker Oats. In 2005 PepsiCo surpassed Coca-Cola Company in market value for the first time in 112 years since both companies began to compete. Over the years PepsiCo has become a global beverage, snack & foods company. PepsiCo owns 5 different billion dollar brands such as Pepsi, Tropicana, Frito Lay, Quaker Oats & Gatorade. PepsiCo also owns other brands such as Diet Pepsi, 7UP, Mirinda, Ruffles Potato Chips, Aquafina Bottled Water, Pepsi Max, Mountain Dew, etc.

Indra Krishnamurthy Nooyi has been the chief executive of PepsiCo since 2006. PepsiCo delivered some solid financial performance in 2009, Its Net

revenue grew by 5%, Core division operating profit grew by 6%, Core earnings per share grew by 6%, Management operating cash flow excluding certain items reached \$5.6 billion up by 16%, Annual Dividend raised by 6%. PepsiCo estimated worldwide retail sales of \$108 billion through all the products. In 2009 PepsiCo's Net Revenue was \$43,232 million, mixed net revenues of 37% from food products and 63% from beverages. Net Revenues generated according to operations in US and outside US are 52% in US and 48% outside US. Net Revenues generated through PepsiCo and its subsidiary companies are 48% by PepsiCo Americas Foods, 23% by PepsiCo Americas Beverages, 29% by PepsiCo International.

## **2.1 – PepsiCo's Strategies for driving growth**

Expand the Global Leadership Position of Snacks Business

Ensure sustainable & profitable growth in global beverages.

Continue to deliver environmental sustainability goals and commitments.

Cherish associates and develop the leadership to sustain growth.

## **2.2 – PepsiCo's Competitive Advantage & Strengths**

PepsiCo's competitive advantage lies in their talented, dedicated and hard working work-force, that work on its huge brands, innovating & producing differentiated products, using excellent marketing methodologies. PepsiCo also uses cost saving initiatives in operations. All these factors help them to sustain a competitive advantage in the market.

PepsiCo's strength lies in its brand name recognized all over the world, huge range of food and beverage products, marketing style in different regions according to the place culture segmentation, and huge marketing budget.

## **CAPITAL STRUCTURE**

The most fundamental question of corporate finance is how a firm should raise capital from investors. A firm must determine the type of security it will issue to the investors. Capital structure refers to the way a firm finances its assets through some combination of equity, debt, or other securities. There are different theories to determine the capital structure of the company.

(3. 1) Pecking Order Theory (developed by Stewart Myers, 1984) states that the firms have a preferred structure for financing; the factor with a high preference uses internal financing such as retained earnings before opting for any external financing. External financing uses debts, convertible securities, preferred stock & common stock. So the firm first uses its retained earnings for operations or investments or expansions and then if required they can opt for external financial resources.

(3. 2) Trade-Off Theory states that the firms are financed partly with equity and partly with debt. Debt financing is preferred here due to the tax benefits of debt. Debt financing also bears bankruptcy and non-bankruptcy costs. Further according to the theory marginal cost of the debts increases as the debt increases and marginal benefits decline as the debt decreases.

(3. 3) Agency Cost Theory states that there are 3 different agency costs related to a firm's capital structure, they are asset substitution, cash flow & underinvestment.

Asset Substitution states that as the debt to equity ratio increases the firm gets more freedom to invest in new projects, this leads to the decline in the value of the firm which results into wealth being transferred from debt holders to shareholders.

Underinvestment problems occur when debt appears to be more risky, in this scenario of the firm the returns from the investment in projects will be directed towards the debt holders rather than the shareholders. This may lead to the firm declining to start any new projects, and there is a potential to increase the firms value.

Free Cash Flow states that free cash flow is also a problem for the firm if the cash is not returned to the investors. Doing so will disrupt the value of the firm.

(3. 4) Modigliani-Miller Theory (developed by Merton Miller & Franco Modigliani) states that it is assumed that there are no transaction costs, no taxes and there is a perfect market condition. They also stated that the value of a firm is determined by adding up all the debts and equity of the firm. This can be viewed through an example

**Firm A**

**Firm B**

**Debt value**

0

2, 500, 000

**Interest on debt**

0

5%

**Expenses on debt**

0

125, 000

**Share**

1, 000, 000

500, 000

**Price per share**

5

5

**Market value of equity**

5, 000, 000

2, 500, 000

From the above table we can see the market value of Firm A is 5million (only equity), Firm A is only financed by shares, therefore the value of Firm A is 5million.

Market value of Firm B is 5million (equity + debt), 50% financed by shares and 50% by debt, but Firm B has to pay interest on the debts which is 5% of

the debt value which is 125, 000. Therefore the returns on equity for Firm B will be its earnings minus the value of interest on debts. Returns per share for Firm B will be returns on equity divided by earnings. If Firm B would have sold its stock at a premium rate then it could have made arbitrage profits.

Modigliani Miller theory states that the value of a firm in a perfect market is not affected by the way the company is financed but it is affected through the sort of capital structure the firm utilizes.

## **PEPSICO'S NET DEBT RATIO**

Debt ratio that indicates the proportion of debt a company has relative to its assets. The measure gives an idea to the leverage of the company along with the potential risks the company faces in terms of its debts. If debt ratio is higher than 1 then the firm has more debt than assets, if debt ratio is less than 1 then the firm has more assets than debts. The formula for calculating debt ratio is,  $\text{Debt Ratio} = \text{total debt} / \text{total assets}$ . Debt Ratio helps to measure the risk a bank or financial institution will take if they are financing a firm.

Net Debt is the measure of a firm's overall debt by taking the net value of debts and cash. Net Debt is calculated as,  $\text{Net Debt} = (\text{long term debt} + \text{short term debt}) - \text{cash \& cash equivalents}$ . According to PepsiCo, they measure net debt ratio on market-value basis where net debt equals total debt. PepsiCo's Net Debt Ratio ( $L^*$ ) =  $(D + \text{PVOL} - \text{CMS}) / (\text{NP} + D + \text{PVOL} - \text{CMS})$ .

D is the market value of total debt (long term debt plus short term debt), PVOL is the present value of operating leases, CMS is the cash & marketable



securities, N is the number of common shares, P is the common stock price. From the assignment referring to exhibit 2 & exhibit 4, all values in millions dollars except for the common stock price,  $D = 9215$ ,  $PVOL = 479 * 5 = 2395$ ,  $CMS = 1498$  and reduce it by 25% for remitting to US therefore  $CMS = 1123.5$ ,  $N = 788$ ,  $P = 55.875$ .

$$L^* = [(9215 + 2395) - 1123.5] / [((788 * 55.875) + 9215 + 2395) - 1123.5]$$

$$L^* = 19.2\% \text{ (PepsiCo's Net Debt Ratio is 19.2\%)}$$

Now to analyze this we can ask some questions as how much debt really exists? If we consider exhibit 2 in the assignment there are other factors like accounts payable, short term debt & other current liabilities which constitute of total current liabilities plus long term debt & other liabilities, all this together shows that the total liabilities are 18,119 million dollars, which is a bit high according to the market situation. That is why this shows the Moody's rating of PepsiCo is A1/A. PepsiCo will have to reduce their liabilities in order to gain a rating of Aa3/AA of Coca-Cola.

What kind of debt is it, long term or short term? Firstly let us talk about short term debt, if we talk about short term debts then we can assume it can be included in current debts, so according to the balance sheet in exhibit 2, total current liability is 5230 million dollars, while total long term liability is 12889 million dollars, so the total long term debt is very high compared to total current liabilities. PepsiCo will have to reduce its long term debts more effectively in order to increase its ratings and also increase its assets.

Can the company afford the debts if it runs into financial trouble? Let us calculate the debt ratio as explained above in the beginning, Debt ratio = total debt / total assets (both values are in million dollars) =  $18119 / 25432 = 0.71$ . If the debt ratio is less than 1 it means that the firm has more assets than debts. So PepsiCo can afford to be debt financed at a certain level.

Looking at the current assets if the company runs into financial trouble then it can clear all its debts by selling off its assets.

## **RATIO COMPARISON & ANALYSIS**

Table of calculated ratios referring to values given in exhibit 5 in assignment,

## **RATIOS**

### **PEPSICO**

### **CADBURY**

### **SCHWEPPE**

### **COCA COLA**

### **COCA COLA ENTERPRISES**

### **MCDONALDS**

## **INTEREST COVERAGE**

**4. 565**

**4. 896**

**16. 911**

**1. 444**

**7. 379**

## **FIXED CHARGE COVERAGE**

**3. 094**

**4. 287**

**16. 911**

**1. 406**

**3. 588**

## **LONG-TERM DEBT**

**0. 165**

**0. 090**

**0.011**

**0.517**

**0.112**

**TOTAL DEBT TO TOTAL ADJUSTED  
CAPITALIZATION**

**0.176**

**0.146**

**0.016**

**0.521**

**0.125**

**CASH FLOW TO LONG TERM DEBT**

**0.427**

**0.569**

**2.730**

**0.155**

**0.539**

**CASH FLOW TO TOTAL DEBT**

**0.395**

**0.330**

**1.839**

**0.153**

**0.474**

Let's look at each ratio one by one in detail and analyze it.

(5. 1) Interest coverage ratio is used to calculate the firm's ability to pay interest on the debts. If the ratio is low the firm has huge debt expenses. If the ratio is less than 1 then it means that the firm is unable to generate revenues to incur the interest expenses. Interest coverage ratio = earnings before interest and taxes (EBIT) / interest expense. According to the table above, we can see that interest coverage ratio of PepsiCo is 4. 565 which is very higher than 1 and is considered as good. Comparing it with other companies in the table, we can see that Coco Cola has the highest ratio of 16. 911 which is very impressive, but Coca Cola Enterprises has a ratio of 1. 44 which is a caution alarm for its investors. To be on a safer side if the ratio is 1. 5 or less then firm's ability to meet its interest expenses can be questionable i. e. the is not able to generate sufficient returns to meet the interest expenses.

(5. 2) Fixed charge coverage ratio is used to calculate the firm's ability to pay its fixed-charges such as rent and interest on debt without increasing the debts. If the ratio is less than 1 then the firm is not able to pay its fixed charges and vice versa. Fixed-charge coverage ratio = (EBIT + fixed charges before tax) / (fixed charged before tax + interest). According to the table above, we can see that PepsiCo's fixed charge coverage ratio is 3. 094 which is greater than 1. Comparing it with other companies in the table, Coca Cola has the highest ratio of 16. 911 which is very impressive, but for Coca Cola Enterprises is 1. 406 which is very less. PepsiCo should decrease its debts in order to reduce its fixed charges which will help to increase the value of the ratio.

(5. 3) Long term debt ratio is used to calculate the firm's leverage. Higher the ratio, higher is the firm's leverage. Firm with a high ratio is considered more risky for investors to invest because they have more liabilities than equity and vice versa. Long term debt ratio = long term debt / (long term debt + preferred stock + common stock). According to the table above, PepsiCo's long term debt ratio is 0. 165 which is less. Comparing to other companies in the table, Coca cola has a ratio of 0. 011 which shows that it has more equity than liability, but Coca Cola Enterprises has a ratio of 0. 517 which shows that it has almost 50% equity and 50% liability, so investing in Coca Cola Enterprises is more risky.

(5. 4) Total debt to total adjusted capitalisation ratio is used to calculate the firm's leverage which includes long term and short term debts. Total debt to total adjusted capitalisation ratio = (long-term debt + short term debt) / [(long-term debt + short term debt) + preferred stock + common stock]. According to the table above, PepsiCo's total debt to total adjusted capitalisation ratio is 0. 176. Comparing to other companies in the table, Coca Cola has a ratio of 0. 016 which shows it has more equity than liability, but Coco Cola Enterprises has a ratio of 0. 521 which is again very risky.

(5. 5) Ratio of cash flow to long term debt is used to calculate the firm's ability to generate cash in comparison with the long term debts. Ratio of cash flow to long term debt = cash flow / long term debt. According to the table above, PepsiCo's ratio of cash flow to long term debt is 0. 427 which is not good enough. Comparing it with other companies, Coca Cola's ratio of cash flow to long term debt is 2. 730, which is very impressive. PepsiCo has more long term debts than its annual cash flow while Coca Cola's annual

cash flow is 3 times the value of its long term debt. Firm's with a high cash flow after interest and taxes are in a better position to distribute cash dividends. Firm with high cash flow can also use the cash to invest in other projects, buy assets, reduce debts etc.

(5. 6) Ratio of cash flow to total debt is used to calculate the firm's ability to generate cash in comparison with its total debts. Ratio of cash flow to total debt =  $\text{cash flow} / \text{total debt}$ . According to the table above, PepsiCo's ratio of cash flow to total debt is 0. 395. Comparing it with other companies, Coca Cola's ratio of cash flow to total debt is 1. 839 which is very good. PepsiCo's total debt is more than twice the value of its annual cash flow while Coca Cola's annual cash flow is 2 times the value of its total debt.

After considering all the ratios in the table, we can say that PepsiCo needs to reduce its debts by a huge margin and generate more cash so that it can use this cash to pay out more dividends to its investors, increase equity and reduce liability, invest in more products, buy assets, etc. Coca Cola is the largest competitor of PepsiCo, so PepsiCo needs to improve its equity in order to compete more effectively with Coca Cola. If company has less debts and liabilities people will invest more which will provide PepsiCo with a good rating as Coca Cola. PepsiCo can easily borrow money from the market for investments and also it can easily pay it back. Even in financial or economic crisis it will be the least affected company. Capital structure of PepsiCo has debt and equity. According to the net debt ratio we can say PepsiCo has about 20% - 25% debt and 75% - 80% equity.

## **PEPSICO'S RATING OBJECTIVE**

Ratings are given to companies depending on various factors such as its debt value, equity value, sources of finance, stock price, number of shares, profits, dividends, etc. Moody rated A as "upper-medium grade", subject to "low credit risk", but that have elements present that suggest a susceptibility to impairment over the long term. PepsiCo has a rating of A1/A which places it in the upper medium grade category. A1 is the high quality rating given to PepsiCo, Aaa is the highest rating available. Coca Cola's rating is Aa3/AA shows that it has much better ratings than PepsiCo.

If PepsiCo wants to have a net debt ratio of 20% - 25% then it will have to increase its debts and reduce equity, if this happens the Corporate Debt Rating of PepsiCo might fall to Baa which is lower medium grade. This will show a bad image of the company in the market, investors will find it risky to invest in PepsiCo. This means people will not buy shares of PepsiCo and it will not be able to raise funds through the issue of share to decrease its debts or to invest in the business. As a result of which they will have to borrow from the banks, Banks would also lend them funds to a certain limit where their assets are equal to liabilities, Banks would like to make sure that PepsiCo are able to pay back the funds with interest before lending them the funds. PepsiCo should reduce their net debt ratio to at least 15% instead of increasing it, due to this they will have more cash flow, reduced debts, can easily pay back dividends to investors, they can easily raise funds through issue of shares instead of borrowing from banks or other financial institutions. This will overall help PepsiCo to increase its ratings from A to Aa.

## **CONCLUSION**

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