American home products corporation essay sample

Finance

American Home Products Corporation1. CASE SUMMARYAHP Chief Executive” I just don’t like to owe money”, said William F. Laporte, AHP chief executive, when asked about his company’s almost debt-free balance sheet and growing cash reserves. Mr. Laporte had taken over as chief executive of American Home Products in 1964. Throughout 17 subsequent years of his tenure Mr. Laporte has not changed his opinion of debt financing and AHP’s abstinence from debt continued, while the growth in its cash balance outpaced impressive growth in both sales and earnings. At the end of 1980, AHP had almost no debt and a cash balance equal to 40% of its net worth.

Description of the CompanyAHP’ 1981 sales of more than $4 billion were produced by over 1, 500 marketed brands in four lines of business: prescription drugs, packaged drugs (i. e. proprietary or over-the-counter), food products, and housewares and household products. Consumer products included a diversity of well-known brand names, such as Anacin, Preparation H, Sani-Flush, Chef Boy-Ar-dee, Gulden’s Mustard, Woolite, and the Ekco line of housewares. AHP’s success in these lines of business was built on marketing expertise. Whether the product was an oral contraceptive or a toilet bowl cleaner, “ they sell the hell out of everything they’ve got”, said one competitor.

AHP’s Distinctive Corporate CultureAHP had a distinctive corporate culture that, in the view of many observers, emanated from its chief executive. This culture had several components: Reticence. A poll of Wall Street analysts ranked AHP last in corporate communicability among 21 drug companies.

Frugality and tight financial control. Reportedly, all expenditures greater than $500 had to be personally approved by Mr. Laporte even if authorized in the corporate budget.

Conservatism and risk aversion. AHP consistently avoided much of the risk of new product development and introduction in the volatile drug industry. Most of its new products were acquired or licensed after their development by other firms or were copies of new products introduced by competitors. A substantial portion of AHP’s new products were clever extensions of existing products. AHP thus avoided risky gambles of R&D and new product introductions and used its marketing prowess to promote acquired products and product extensions.

Long-standing policy of centralizing complete authority in the chief executive. Mr. Laporte’s management style was characterized as management from the top, unparalleled in any firm of comparable size. Mr. Laporte stated the objective underlying his use of this authority as “ we run the business for the shareholders”. The author of a Business Week article on the firm commented: “ One of the most common business platitudes is that a corporation’s primary mission is to make money for its stockholders and to maximize profits by minimizing costs. At American Home, these ideas are a dogmatic way of life”.

AHP’s PerformanceAHP’s managerial philosophy produced impressive results: AHP’s performance was characterized by stable, consistent growth and profitability. The firm had increased sales, earnings, and dividends for 29 consecutive years through 1981. Exhibit 1 illustrates 10-year review of AHP's performance.

During Mr. Laporte's reign as chief executive AHP's price-earnings ratio had fallen by about 60%, reflecting the market-wide collapse of price-earnings ratios of growth companies. Nonetheless, AHP's substantial growth in earnings per share had pushed up the value of its stock by factor of three during of his tenure. Its popularity among investors reflected analysts' assessment of AHP's management. Nevertheless, AHP's liquidity and low degree of leverage were criticized by many analysts.

In 1981, after 17 years as chief executive, Mr. Laporte was approaching retirement, and analysts speculated on the possibility of a more aggressive capital structure policy.

2. QUESTIONSQUESTION 1How much business risk does American Home Products face? How much financial risk would American Home Products face at each of the proposed levels of debt shown in case Exhibit 3? How much potential value, if any, can American Home Products create for its shareholders at each of the proposed levels of debt? ANSWER: In corporate finance, Hamada's equation is used to separate the financial risk of a levered firm from its business risk. It is used to help determine the levered beta and, through this, the optimal capital structure of corporate firms.

The equation is: where βL and βU are the levered and unlevered betas, respectively, T the tax rate and D/E the leverage, defined here as the ratio of debt, D, to equity, E, of the firm.

The importance of Hamada's equation is that it separates the risk of the business, reflected here by the beta of an unlevered firm, βU, from that of its levered counterpart, βL, which contains the financial risk of leverage.

Thus to know how much business risk does American Home Products face we have to calculate its βU.