Hansson private label case essay sample

Evaluating an investment in expansion and providing a recommendation to Hansson Private Label, Inc.

Tucker Hansson, the owner of Hansson Private Label, is struggling in whether to execute the $50 million investment proposed by his manufacturing team. Under this situation, the subject of this report is to evaluate the potential investment of expanding production capacity at Hansson Private Label (HBL) and make a recommendation to Tucker Hansson. In this report, I will specifically focus on analyses of the project's free cash flows (FCFs), weighted average cost of capital (WACC) and net present value (NPV). With a sensitivity analysis, it can help us to observe how change in some key project variables would make the project stronger and weaker. This report can provide efficient information for Hansson to evaluate the potential value of this investment and help him to make a final decision.

HPL and private label personal care industry

HPL is a midsize manufacturer of private label personal care products that sold under the brand label of its retail customers which included supermarkets, drug stores and mass merchants. The great achievement of HPL in personal care products market depends on its focusing on manufacturing efficiency, expense management and customer service to guarantee stable sales growth. As a conservative businessman, Hansson has always been careful about capacity expansion and he never allows capacity utilization to be below 60%. HPL has a significant share of private label personal care market. The growth of sales of company's products has remained stable and generated $681 million in revenue in 2007 accounting for more than 28% share of U. S domestic consumption.

However, the competition of this kind of products is fierce and the current capacity of HPL is getting close to full. In addition, over the past four years, the unit volumes had increased only by 1% per year, and there is no more room for further growth in revenues if the company do not expand a new facility because all four plants' capacity utilization is operating at more than 90%. HPL is experiencing a critical juncture that it has an opportunity to expand its capacity by signing a three-year contract with its biggest retail customer. However, this $50 million contract is committed to only three-year. In addition, as we know, there is no investment without risks. The HPL's current debt would likely to be doubled and the financial leverage would likely to be increased by this interment. Consequently, HPL's financial stability would be seriously jeopardized by any financial distress from the customer.

Free cash flows

As a measure of financial performance, FCF represents a company's ability to generate money after the requirement of money that spent on maintaining or expanding its asset base. FCF is important for a company since a company can use this money to enhance its productivity. Without cash, it is difficult for a company to develop new product types, make acquisitions, and pay off debt. According to the assumptions made by Executive VP of Manufacturing, Robert Gates, the project's FCFs are estimated to be positive (the detail FCFs are shown in exhibit 1). However, I find that these assumptions are not realistic. This can be explained by two reasons. Firstly, the contact proposed by the biggest customer is only committed to 3 years. After 3 years, this contact might be terminated, while

the period of Cates's financial estimation is based on 10 years. Therefore, the estimation of project's FCF is not realistic. Secondly, the manufacturing team realized that there will be more risks tolerated by the company than before after taking this project. However, Gates just used historical data which risk is steady in the lower lever to make these financial assumptions. So, in another work, these projections are not accurate.

Weighted average cost of capital (WACC)

When estimating a project's NPV, the choice of discount rate is important because the project's viability could be significantly affected. For HPL, An estimate of the company's WACC had always been used as the discount rate for new projects. General speaking, WACC is the rate that a company's shareholders expect to be paid on average to finance its assets, and it is the overall required return on the firm as a whole. Therefore, company directors often use WACC to determine whether a financial decision is feasible or not. In this case, I will choose 9. 38% as discount rate. The reason why I choose 9. 38% as discount rate is because the estimated Debt/Equity is 26% under the assumptions by CFO Sheila Dowling, which is most close to 25% of Debt/Equity from the projected WACC schedule. There might be some flaws existing by using WACC as discount rate. As we know, the cost of debt would be raised significantly as the leverage increased. The investment will definitely increase the firm's current debt. So, the cost of debt would not keep at 7. 75%.

Net present value

NPV analysis uses future cash flows to estimate the value that a project could add to a firm's shareholders. A company director or shareholders can

be clearly provided the present value of a long-term project by this approach. By estimating a project’s NPV, we can see whether the project is profitable. Despite NPV analysis is only based on financial aspects and it ignore non-financial information such as brand loyalty, brand goodwill and other intangible assets, NPV analysis is still the most popular way evaluate a project by companies. In this report, I used free cash flows as projected cash flows and the WACC of 9. 38% associated to a company with similar leverage. The project’s NPV is estimated in $ 22720. 09, which is shown in exhibit 1.

Sensitivity analysis

In order to measure how sensitive the project’s NPV is to some key project variables, a sensitivity analysis is required based on two inputs that growth rate of selling price per unit and growth rate of raw material cost per unit. There are some assumptions about these two variables in exhibit 2. I assumed that growth rate of these two inputs increase or decrease by 10%. Based on these assumptions, we find the difference of the highest NPV and the lowest NPV is $53, 531. 32 and $14. 327. 68 respectively. This indicates that the project’s NPV is more sensitivity to growth rate of selling price per unit than growth rate of raw material cost per unit. It represents price changes have higher risk to the success of project. Figure 1. Sensitivity analysis based on input of growth rate of selling price per unit

Figure 2. Sensitivity analysis based on input of growth rate of raw material cost per unit

Recommendation

After a series of analyses toward FCFs, WACC and NPV, although the estimate of the project’s FCFs is not realistic and the projected WACC schedule did not consider the effect of new investment on financial leverage, the positive project’s NPV means the project is still profitable and favourable. In conclude, I will recommend Tucker Hansson proceed with the investment.