DARDEN BUSINESS PUBLISHING
UNIVERSITY of VIRGINIA

UV5147
Rev. Jan. 6, 2016

H. J. Heinz: Estimating the Cost of Capital in Uncertain Times

To do a common thing uncommonly well brings success.

—H. J. Heinz Founder Henry John Heinz

As a financial analyst at the H. J. Heinz Company (Heinz) in its North American Consumer Products division, Solomon Sheppard, together with his co-workers, reviewed investment proposals involving a wide range of food products. Most discussions in his office focused on the potential performance of new products and reasonableness of cash flow projections. But as the company finished its 2010 fiscal year at the end of April—with financial markets still in turmoil from the onset of the recession that started at the end of 2007—the central topic of discussion was the company's weighted average cost of capital (WACC).

At the time, there were three reasons the cost of capital was a subject of controversy. First, Heinz's stock price had just finished a two-year roller coaster ride: Its fiscal year-end stock price dropped from $47 in 2008 to $34 in 2009, then rose back to $47 in 2010, and a vigorous debate ensued as to whether the weights in a cost of capital calculation should be updated to reflect these changes as they occurred. Second, interest rates remained quite low—unusually so for longer-term bond rates; there was concern that updating the cost of capital to reflect these new rates would lower the cost of capital and therefore bias in favor of accepting projects. Third, there was a strong sense that, as a result of the recent financial meltdown, the appetite for risk in the market had changed, but there was no consensus as to whether this should affect the cost of capital of the company and, if so, how.

When Sheppard arrived at work on the first of May, he found himself at the very center of that debate. Moments after his arrival, Sheppard's immediate supervisor asked him to provide a recommendation for a WACC to be used by the North American Consumer Products division. Recognizing its importance to capital budgeting decisions in the firm, he vowed to do an "uncommonly good" job with this analysis, gathered the most recent data readily available, and began to grind the numbers.

Heinz and the Food Industry

In 1869, Henry John Heinz launched a food company by making horseradish from his mother's recipe. As the story goes, Heinz was traveling on a train when he saw a sign advertising 21 styles of shoes, which he thought was clever. Since 57 was his lucky number, the entrepreneur began using the slogan "57 Varieties" in his advertising. By 2010, the company he eventually founded had become a food giant, with $10 billion in revenues and 29,600 employees around the globe.

Heinz manufactured products in three categories: Ketchup and Sauces, Meals and Snacks, and Infant Nutrition. Heinz's strategy was to be a leader in each product segment and develop a portfolio of iconic brands. The firm estimated that 150 of the company's brands held either the number one or number two position in their respective target markets.[1] The famous Heinz Ketchup, with sales of $1.5 billion a year or 650 million bottles sold, was still the undisputed world leader. Other well-known brands included Weight Watchers (a leader in dietary products), Heinz Beans (in 2010, the brand sold over 1.5 million cans a day in Britain, the "biggest bean-eating nation in the world"), and Plasmon (the gold standard of infant food in the Italian market).[2] Well-known brands remained the core of the business with the top 15 brands accounting for about 70% of revenues, and each generating over $100 million in sales.

Heinz was a global powerhouse. It operated in more than 200 countries. The company was organized into business segments based primarily on region: North American Consumer Products, U.S. Foodservice, Europe, Asia Pacific, and Rest of World. About 60% of revenues were from outside the United States and the North American Consumer Products and Europe segments were of comparable size. Increasingly, the company was focusing on emerging markets, which had generated 30% of recent growth and comprised 15% of total sales.

The most prominent global food companies based in the United States included Kraft Foods, the largest U.S.-based food and beverage company; Campbell Soup Company, the iconic canned food maker; and Del Monte Foods, one of largest producers and distributers of premium-quality branded food and pet products focused on the U.S. market (and a former Heinz subsidiary). Heinz also competed with a number of other global players such as Nestlé, the world leader in sales, and Unilever, the British-Dutch consumer goods conglomerate.

Recent Performance

With the continued uncertainty regarding any economic recovery and deep concerns about job growth over the previous two years, consumers had begun to focus on value in their purchases and to eat more frequently at home. This proved a benefit for those companies providing food products and motivated many top food producers and distributors to focus on core brands. As a result, Heinz had done well in both 2009 and 2010, with positive sales growth and profits above the 2008 level both years, although 2010 profits were lower than those in 2009. These results were particularly striking since a surge in the price of corn syrup and an increase in the cost of packaging had necessitated price increases for most of its products. Overseas sales growth, particularly in Asia, had also positively affected the company's operations. **Exhibit 1** and **Exhibit 2** present financial results for the years 2008, 2009, and 2010.

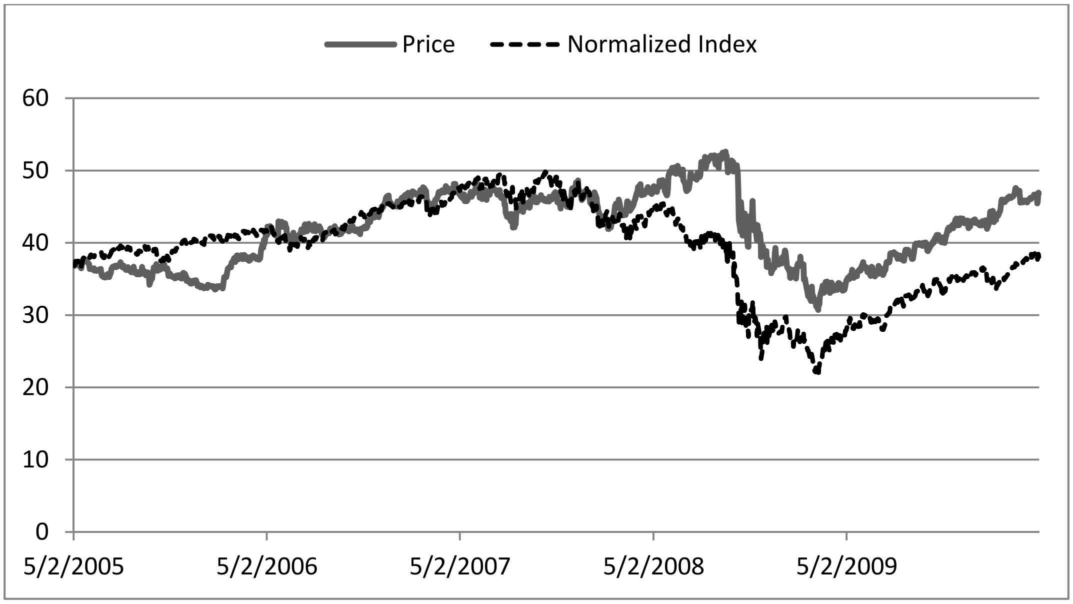
The relation between food company stock prices and the economy was complicated. In general, the performance of a food products company was not extremely sensitive to market conditions and might even benefit from market uncertainty. This was clear to Heinz CFO Art Winkelblack, who in early 2009 had remarked, "I'm sure glad we're selling food and not washing machines or cars. People are coming home to Heinz."[3] Still an exceptionally prolonged struggle or another extreme market decline could drive more consumers to the private-label brands that represented a step down from the Heinz brands. While a double-dip recession seemed less likely in mid-2010, it was clear the economy continued to struggle, and this put pressure on margins.

While the stock price for Heinz had been initially unaffected by adverse changes in the economy and did not decline with the market, starting in the third quarter of 2008, Heinz's stock price began tracking the market's

[1] "H. J. Heinz Corporate Profile," http://www.heinz.com/our-company/press-room.aspx (accessed Sep. 27, 2010).
[2] http://www.heinz.com/our-company/press-room.aspx.
[3] Andrew Bary, "The Return of the Ketchup Kid," *Barron's,* January 26, 2009.

movement quite closely. **Figure 1** plots the Heinz stock price against the S&P Index (normalized to match Heinz's stock price at the start of the 2005 fiscal year). The low stock price at the start of 2009 had been characterized by some as an over-reaction and, even with the subsequent recovery, it was considered undervalued by some.[4]

Figure 1. Heinz stock price and normalized S&P 500 Index.



Data sources: S&P 500 and Yahoo! Finance.

Cost of Capital Considerations

Recessions certainly could wreak havoc on financial markets. Given that the recent downturn had been largely precipitated by turmoil in the capital markets, it was not surprising that the interest rate picture at the time was unusual. **Exhibit 3** presents information on interest rate yields. As of April 2010, short-term government rates and even commercial paper for those companies that could issue it were at strikingly low levels. Even long-term rates, which were typically less volatile, were low by historic standards. Credit spreads, which had drifted upwards during 2008 and jumped upwards during 2009, had settled down but were still somewhat high by historic standards. Interestingly, the low level of long-term rates had more than offset the rise in credit spreads, and borrowers with access to debt markets had low borrowing costs.

Sheppard gathered some market data related to Heinz (also shown in **Exhibit 3**). He easily obtained historic stock price data. Most sources he accessed estimated the company's beta using the previous five years of data at about 0.65.[5] Sheppard obtained prices for two bonds he considered representative of the company's outstanding borrowings: a note due in 2032 and a note due in 2012. Heinz had regularly accessed the commercial paper market in the past, but that market had recently dried up. Fortunately, the company had other sources for short-term borrowing and Sheppard estimated these funds cost about 1.20%.

[4] Bary; the same article noted that Heinz had "an above-average portfolio of brands, led by its commanding global ketchup franchise" and, even at January 2009 prices, could be a takeover target.

[5] Sheppard was sufficiently curious as to whether this number was still relevant that he calculated his own estimated of beta from the last year of daily returns. His estimate was 0.54, close to the five-year estimate from Value Line, but still notably lower.

What most surprised Sheppard was the diversity of opinions he obtained regarding the market risk premium. Integral to calculating the required return on a company's equity using the capital asset pricing model, this rate reflected the incremental return an investor required for investing in a broad market index of stocks rather than a riskless bond. When measured over long periods of time, the average premium had been about 7.5%.[6] But when measured over shorter time periods, the premium varied greatly; recently the premium had been closer to 6.0% and by some measures even lower. Most striking were the results of a survey of CFOs indicating that expectations were for an even lower premium in the near future—close to 5.0%. On the other hand, some asserted that market conditions in 2010 only made sense if a much higher premium—something close to 8%—were assumed.

As Sheppard prepared for his cost of capital analysis and recommendation, he obtained recent representative data for Heinz's three major U.S. competitors (**Exhibit 4**). This information would allow Sheppard to generate cost-of-capital estimates for these competitors as well as for Heinz. Arguably, if market conditions for Heinz were unusual at the time, the results for competitors could be more representative for other companies in the industry. At the very least, Sheppard knew he would be more comfortable with his recommendation if it were aligned with what he believed was appropriate for the company's major competitors.

[6] After some research, Sheppard was confident that the appropriate rate was the arithmetic mean (simple average) of past annual returns rather than the geometric mean in this context. The reason was that the arithmetic mean appropriately calculates the present value of a distribution of future cash flows.

Exhibit 1

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Income Statement
(numbers in thousands except per-share amounts; fiscal year ends in April)

	2008	2009	2010
Revenue	9,885,556	10,011,331	10,494,983
Costs of goods sold	6,233,420	6,442,075	6,700,677
Gross profit	3,652,136	3,569,256	3,794,306
SG&A expense	2,081,801	2,066,810	2,235,078
Operating income	1,570,335	1,502,446	1,559,228
Interest expense	323,289	275,485	250,574
Other income (expense)	(16,283)	92,922	(18,200)
Income before taxes	1,230,763	1,319,883	1,290,454
Income taxes	372,587	375,483	358,514
Net income after taxes	858,176	944,400	931,940
Adjustments to net income	(13,251)	(21,328)	(67,048)
Net income	844,925	923,072	864,892
Diluted EPS	2.61	2.89	2.71
Dividends per share	1.52	1.66	1.68

Data source: H. J. Heinz SEC filings, 2008–10.

Exhibit 2

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Balance Sheet
(numbers in thousands except per-share amounts; fiscal year ends in April)

	2008	2009	2010
Cash	617,687	373,145	483,253
Net receivables	1,161,481	1,171,797	1,045,338
Inventories	1,378,216	1,237,613	1,249,127
Other current assets	168,182	162,466	273,407
Total current assets	3,325,566	2,945,021	3,051,125
Net fixed assets	2,104,713	1,978,302	2,091,796
Other noncurrent assets	5,134,764	4,740,861	4,932,790
Total assets	10,565,043	9,664,184	10,075,711
Accounts payable	1,247,479	1,113,307	1,129,514
Short-term debt	124,290	61,297	43,853
Current portion of long-term debt	328,418	4,341	15,167
Other current liabilities	969,873	883,901	986,825
Total current liabilities	2,670,060	2,062,846	2,175,359
Long-term debt	4,730,946	5,076,186	4,559,152
Other noncurrent liabilities	1,276,217	1,246,047	1,392,704
	6,007,163	6,322,233	5,951,856
Equity	1,887,820	1,279,105	1,948,496
Total liabilities and equity	10,565,043	9,664,184	10,075,711
Shares outstanding (in millions of dollars)	311.45	314.86	317.69

Data source: H. J. Heinz SEC filings, 2008–10.

Exhibit 3

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Capital Market Data
(yields and prices as of the last trading day in April of the year indicated)

Average Historic Yields

	2003	2004	2005	2006	2007	2008	2009	2010
1-year	1.22%	1.55%	3.33%	4.98%	4.89%	1.85%	0.49%	0.41%
5-year	2.85%	3.63%	3.90%	4.92%	4.51%	3.03%	2.02%	2.43%
10-year	3.89%	4.53%	4.21%	5.07%	4.63%	3.77%	3.16%	3.69%
30-year[1]	4.79%	5.31%	4.61%	5.17%	4.89%	4.49%	4.05%	4.53%
Moody's Aaa	5.53%	5.87%	5.21%	5.95%	5.40%	5.51%	5.45%	5.13%
Moody's Baa	6.65%	6.58%	5.97%	6.74%	6.31%	6.87%	8.24%	6.07%
3-month commercial paper	1.21%	1.08%	2.97%	4.90%	5.22%	1.91%	0.22%	0.24%

Heinz Capital Market Prices of Typical Issues

	2009	2010
Heinz stock price	$34.42	$46.87
Bond price: 6.750% coupon, semiannual bond due 3/15/32 (Baa rated)	91.4	116.9
Bond price: 6.625% coupon, semiannual bond due 10/15/12 (Baa rated)	116.5	113.7

Note that bond data were slightly modified for teaching purposes.

Data sources: Federal Reserve, Value Line, Morningstar, and case writer estimates.

[1] The 20-year yield is used for 2003–05, when the 30-year was not issued.

Exhibit 4

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Comparable Firm Data

	Kraft	Campbell Soup	Del Monte
Financial Summary			
Revenues (in millions of dollars)	40,386	7,589	3,739
Book value of equity (in millions of dollars)	25,972	728	1,827
Book value of debt (in millions of dollars)	18,990	2,624	1,290
Market Data			
Beta	0.65	0.55	0.70
Shares outstanding (in millions of dollars)	1,735	363	182
Share price (dollars as of close April 30, 2010)	29.90	35.64	15.11
Typical Standard & Poor's bond rating	BBB−	A	BB
Representative yield on long-term debt	5.12%	4.36%	6.19%

Data sources: Value Line; H. J. Heinz SEC filings, 2008–10; case writer estimates; Morningstar.