Hewlett-Packard Capital Structure

Case Study

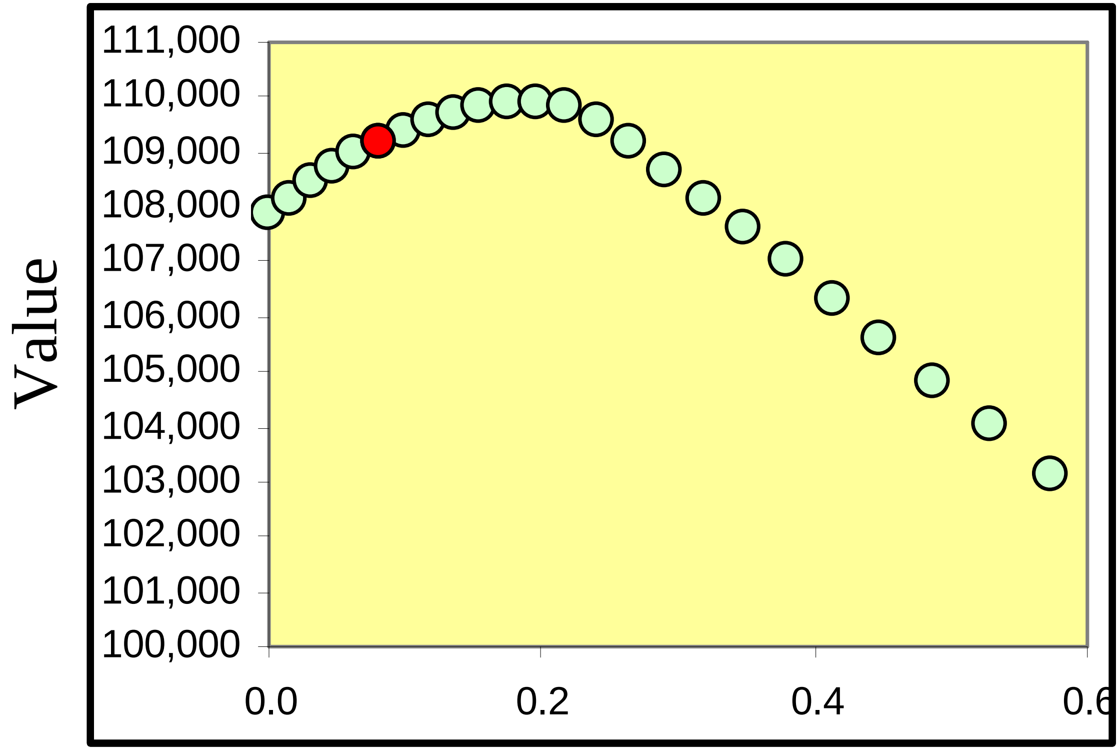
Financial Statement

- Simplified financial statement as of 3Q2008
- Enterprise value of $109B (Debt + Market Equity) is used
- AA Credit rating calculated, which is consistent with HP's S&P rating

Company name	Hewlett-Packard
TABLE I	
Income Statement	
Operating EBITDA	*11,424.0*
D&A	*-2,705.0*
EBIT	*8,719.0*
Other income	*989.0*
Gross interest expense	*-531.0*
EBT	*9,177.0*
Tax	*-1,913.0*
Net profits	*7,264.0*
Balance Sheet	
Assets	*109,183.0*
Market equity	*101,000.0*
IB debt	*8,183.0*
Total liab. & equity	*109,183.0*

TABLE II	
Input/Output Parameters	
Effective tax rate	*21%*
Pre-tax cost of debt	*6.49%*
Implied spread	*0.36%*
Implied risk-free rate	*6.13%*
Implied rating	*AA*
V = D+E	*109,183.0*
V = D*+E*	*109,666.5*
Vu=(1-T)D*+E*	*107,859.9*

Capital Structure Curve



Model output shows the company’s “value” curve based on the financial statement shown on the previous page. This is the inverse of the *WACC* curve.

In the News

Microsoft, Hewlett-Packard and Nike Announce Buyback Plans for Shares

By MICHAEL M. GRYNBAUM

Published: September 22, 2008

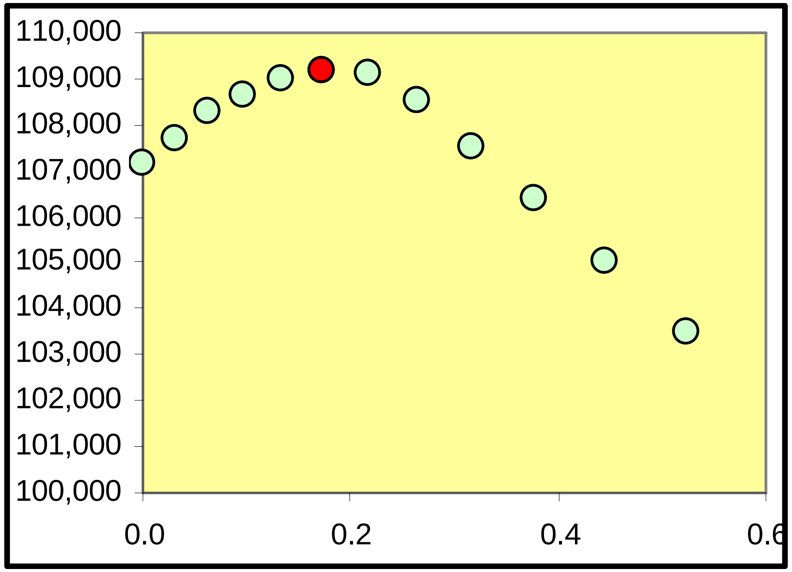
… Microsoft said it would buy back $40 billion of its shares and raise its quarterly dividend by 2 cents, to 13 cents a share. Hewlett-Packard will repurchase $8 billion in shares, and Nike said it would buy back $5 billion. …

Model Output – Scenario 1

Consider $8B equity buyback is financed by $8B debt issue

Table III	
Additional equity	-8,000
Additonal debt	8,000
Total additional assets	***0***
% Impact on EBIT	***-1%***

Implied rating	***A+***



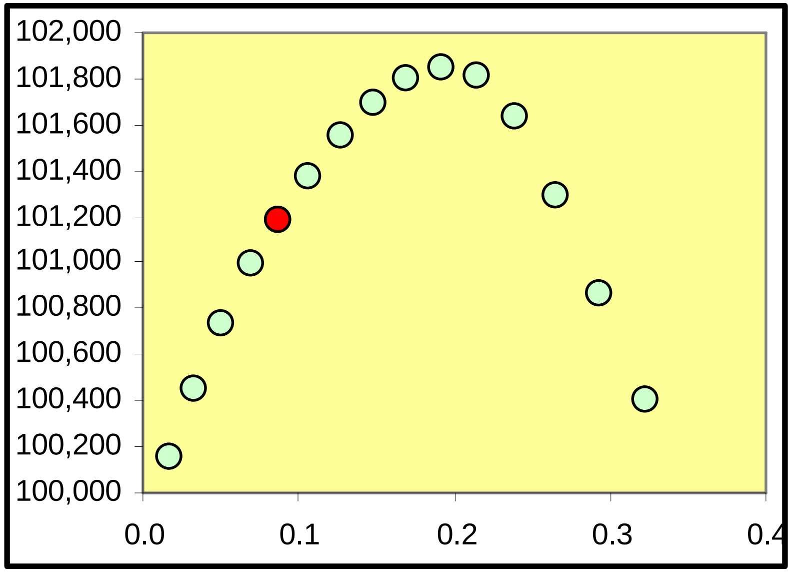
The model shows that this scenario of $8B debt-financed equity buyback will push the capital structure to the optimal, giving HP a new rating of A+ (red point in graph). There is, however, a slight drop in EBIT because of the debt-equity swap. Will HP be happy with this? Possibly, but let's check out other scenarios.

Model Output – Scenario 2

How about $8B equity buyback, all financed by cash/asset sales?

Table III	
Additional equity	-8,000
Addititonal debt	0
Total additional assets	***-8,000***
% Impact on EBIT	***-7%***

Implied rating	***AA***



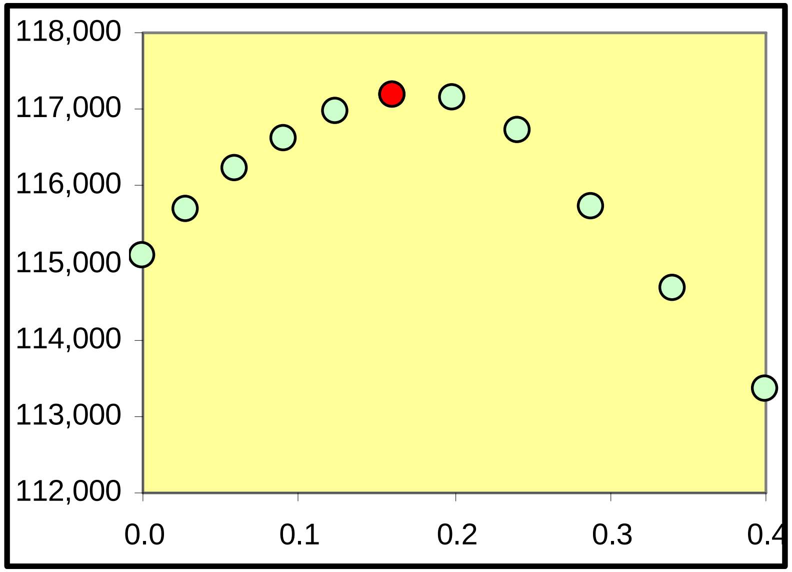
The model shows that this scenario will maintain both the underleveraged standing of the company, as well as its original credit rating of AA. However, the EBIT has fallen by 7% due to contraction in company size. Therefore, this scenario offers no improvement over the original capital structure.

Model Output – Scenario 3

Now consider $8B debt issue to finance $8B in new assets

Table III	
Additional equity	0
Additonal debt	8,000
Total additional assets	***8,000***
% Impact on EBIT	***7%***

Implied rating	***A+***



This scenario pushes the capital structure to the optimal, similar to Scenario 1 (red point in graph). The rating of A+ is also the same, but the expansion in company size increases the EBIT by 7%. Therefore HP may want to consider purchasing new assets rather than buying back its equity, assuming the right assets are available.

References

MS Excel Model for Hewlett-Packard Case Study:

http://rdcohen.50megs.com/Case_Studies/Hewlett_Packard.xls

Methodology:

http://rdcohen.50megs.com/OCSabstract.htm

Other material at:

http://rdcohen.50megs.com/capstruct.htm