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
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.
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

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.

Ruben D. Cohen
Model Output – Scenario 2

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

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

<table>
<thead>
<tr>
<th>Additional equity</th>
<th>0</th>
</tr>
</thead>
<tbody>
<tr>
<td>Additional debt</td>
<td>8,000</td>
</tr>
<tr>
<td>Total additional assets</td>
<td>8,000</td>
</tr>
<tr>
<td>% Impact on EBIT</td>
<td>7%</td>
</tr>
</tbody>
</table>

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.

Ruben D. Cohen
References

MS Excel Model for Hewlett-Packard Case Study:
http://rdcohen.50megs.com/Case_Studies/Hewlett_Packard.xls

Methodology:
http://rdcohen.50megs.com/OCSababstract.htm

Other material at:
http://rdcohen.50megs.com/capstruct.htm