A Financial Capital Structure Analysis of the Food and Technology & Hardware Industries

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Abstract

Capital budgeting is one of the most important functions of a financial manager. Juggling the amount of equity and debt used to minimize weighted average cost of capital and maximize shareholder value is a difficult task, which depends on the organization's performance, sustained growth, and the overall market environment. Additionally, the capital structure requirements of firms in similar industries tend to follow similar patterns, particularly in relationship to financial leverage and cost of capital. This analysis compares the capital structure of three firms each within the food and technology industries, and provides an analysis of that capital structure and recommendations to improve efficiency, company performance, and overall shareholder value. We have selected Eaton Corporation. Snap-on Tools and Stanley Works as part of Technology firms and Sonic, Wendy's and McDonalds' as part of the food industry. The following sections discuss the capital structure of the above companies.

Technology and Hardware Industry

Snap-on Incorporated

Snap-on Incorporated is a leading global developer, manufacturer and marketer of tool and equipment solutions for professional tool users. Product lines include hand tools, power tools, automotive diagnostics and shop equipment, tool storage products, automotive diagnostics software and other solutions for the transportation service, industrial, government, education, agricultural, and other commercial applications, including construction and electrical. Products are sold through its franchise dealer van,

company direct sales and distributor and Internet channels. Founded in 1920, Snap-on is a $2.4 billion S&P 500 company headquartered in Kenosha, Wisconsin, and employs approximately 11,500 people worldwide.

Current Capital Structure

D/(D+E)	Beta	Cost of Equity	Cost of Debt	WACC
11.9%	1.11	11.22%	3.48%	10.3%

Optimal Capital Structure

D/(D+E)	Beta	Cost of Equity	Cost of Debt	WACC
30%	1.30	12.31%	4.55%	9.98%

Capital Structure Discussion

Information for Snap-on was compiled from a variety of sources, namely Yahoo Financials, for balance sheet and income statement information, and SEC Form 10-K filings as found in the EDGAR database and on its own site, for operating lease information. As evidenced by the financial analysis in this report, Snap-on Incorporated is deviating significantly from its optimal capital structure primarily in its debt ratio. The financial management decision to not leverage the company with more debt is driving up the weighted average cost of capital (or WACC) from an optimal rate of 9.98% at a 30% debt ratio to 10.30% at its current debt ratio of 11.90%. Though the debt ratio, controllable to a large extent by corporate management, is off by 18 percentage points, the overall effect on the organization is minimal. The difference in WACC is a mere 0.32%. Furthermore, in its “suboptimal” state, as concluded by the Excel analysis, it has a lower beta, cost of equity, and cost of debt than the optimal debt ratio would provide.

It is clear, then, why Snap-on's managers are pursuing a financial management strategy of reduced financial leverage. The WACC benefit to taking on debt is only thirty-two basis points. It is questionable whether making a significant portion of the firm's capital structure into debt would be worth the increased risk of holding the debt. Unlike stockholders, who can be rewarded in the form of dividends at the firm's discretion, creditors hold claims on the firm's assets and require regular debt service.

Another potential reason why Snap-on may be avoiding financing its projects with more debt is it may be making itself an attractive acquisition target. A review of Snap-on's balance sheet shows that cash, cash equivalents, and receivables account for 68% of its total assets. With a large percentage of liquid assets and relatively little debt, Snap-on's shareholders, who own a stake in a company with a less than 4% sustained growth rate, may benefit by an acquisition offer at a premium from a competitor or other entity. On the other hand, Snap-on's management may be passing up opportunities to increase shareholder value by holding an inordinately large amount of cash and failing to invest adequately into research and development or addressing new markets and market segments.

Recommendations

We recommend that Snap-on avoid new equity issues and finance new projects that require external financing through debt issuance. Modestly increasing the firm's leverage will reduce, however slightly, the weighted average cost of capital, and it may help stave off hostile takeover bids. We also recommend Snap-on to identify new projects that carry a suitable amount of risk that the firm may have been passing up because of its relatively high WACC. The firm's cash would be much better spent

earning a higher-than-WACC return for its shareholders, rather than collecting risk-free, or near risk-free, returns in short-term asset accounts.

Stanley Works

The Stanley Works is a worldwide manufacturer and marketer of tools, hardware and specialty hardware products for home improvement, consumer, industrial and professional use. According to information and data taken from Stanley Works website, the company was founded in 1843. The secret to their success is summed up in one word on their website: Excellence. In order to calculate the capital structure, data was taken directly from the Stanley Works' website in their financial reports from 2005 and previous years. From the website, enough data was taken to calculate the current and optimal capital structures below.

Current Capital Structure

D/(D+E)	Beta	Cost of Equity	Cost of Debt	WACC
19.02%	1.58	13.85%	4.63%	12.09%

Optimal Capital Structure

D/(D+E)	Beta	Cost of Equity	Cost of Debt	WACC
50%	2.45	18.72%	5.19%	11.95%

Capital Structure Discussion

Stanley Works' current capital structure is significantly different than the optimal capital structure. Their cost of equity is the most dissimilar calculation between current and optimal. Their cost of debt and weighted average cost of capital is very similar to the

optimal levels. The beta measurement is also extremely different than the optimal level which most likely means that Stanley is not competing against the market as well as necessary. However, the difference in the suggested optimal WACC and the current WACC is only 0.14%, and the required capital structure adjustment to achieve this modest change in the WACC would mean a major restructuring of the capital structure, requiring additional leverage to bring the debt ratio to 50%. This much leverage would significantly increase Stanley's exposure to risk, amplifying the potential gains and losses the company may generate. Given Stanley Work's sustained growth rate is 13.75%, such heavy leveraging may benefit shareholders; however, it also carries substantial risk should Stanley's performance cool.

Stock Price Discussion

Stanley Works' stock price at year-end 2005 was $48.04. According to the calculations, Stanley Works' Gordon Growth Model stock price is -$8.88. Because this number is negative, it indicates that the growth is higher than the cost of equity, which is below the optimal level. The stock price using intrinsic valuation is $75.06. According to this model, Stanley Works' stock price is undervalued. The stock price when looking at Free Cash Flow is -$23.40. When looking at Free Cash Flow, the stock price is overvalued because they have negative cash flow after they have met all their other obligations. This could mean that the company needs to focus more on internal financing.

Recommendations

Stanley Works' is a company that has been in business for over 150 years. They will most likely continue for another 150 years. They have maintained their reputation for excellence. It is recommended the Stanley Works focus more on their cost of equity. It is low in comparison to the optimal level. Their stock price is undervalued when evaluating it with the intrinsic valuation method, so they should also focus on ways of raising their stock price. They may need to work on their communication of projects that will add value to the firm, so the stock price can include the anticipated future earnings from these projects leading to a more efficient market. The company has a low debt ratio. This indicates that they are not high risk, but they may be passing by opportunities to finance cheaper through outside creditors. They need to strive for their ideal combination of debt and equity financing.

Eaton Corporation

Eaton Corporation is a diversified industrial manufacturing company with net sales over $11 billion dollars and employee strength of more than 60,000. It operates all over the world with head quarters at Cleveland. Inputs from the Yahoo Financials website and the Eaton website were used to calculate the company's current and optimal capital structures. The inputs and detailed results are located in the appendix at the end of this report. A summary of the results are listed here.

Current Capital Structure

D/(D+E)	Beta	Cost of Equity	Cost of Debt	WACC
16.41%	1.82	15.19%	3.8%	13.32%

Optimal Capital Structure

D/(D+E)	Beta	Cost of Equity	Cost of Debt	WACC
70.00%	4.24	28.77%	4.97%	12.11%

Capital Structure Discussion

The results show significant differences in the current capital structure versus the optimal capital structure for debt-to-equity (D/(D+E)), beta, and cost of equity, while the company's current cost of debt and weighted average cost of capital (WACC) indicate that they are operating at optimal conditions. Eaton's current capital structure appears less than typical for a diversified manufacturing industry. Most companies in this segment use more debt to finance their operations versus using internal sources of cash. This can be explained by the fact tat Eaton Corporations optimal capital structure is 70% and their current debt ratio is well below that. The current beta of 1.82 compared to an optimal value of 4.2 indicates that Eaton may be encouraging investors by showing that their stock prices may provide huge returns as the systematic risk is higher. In the current case, if the stock market increases by one percent, then the price of Eaton stock would increase by 1.82 percent. However, the optimal beta suggests a heavy market influence.

While Eaton's capital structure does not seem to follow that of the typical manufacturing industry of its kind, it does follow predictions of the Pecking Order Hypothesis. This hypothesis claims that debt ratios and profitability are inversely related. If a firm is profitable, it does not need to borrow money to capture any tax advantages of debt (*Corporate Finance*, Smart, Megginson, Gitman). This appears to be the philosophy of Eaton Corporation. They are so profitable that they can provide internal resources for research and development, capital investments, and other needs. It should be noted

however, that they do have a D/(D+E) of 16.41% percent and that the current cost of debt is 3.8%, which is almost close to being optimal.

Stock Price Discussion

The market price of Eaton Corporation when we collected this data, about two weeks ago was $70.52. Prices using the Gordon Growth Model (GGM) and intrinsic valuation are $68.48 and $113.32 respectively. The market price is close to the estimation of the Gordon Growth model and is little off from the intrinsic valuation methodology. One possible explanation to this would be the lesser capital expenditures they have and they must be using their assets in a much effective manner. Their capital expenditures are very low and hence the intrinsic value of their stock is high when compared to the market price and as predicted by Gordon growth model. Another possible explanation for the lower stock price compared to intrinsic valuation method is that of the pecking order hypothesis. Eaton may try to increase the leverage by issuing equity and investors may perceive this as “bad news” thus lower the stock price. Investors may be under the assumption that the only reason a company is issuing equity is because they think that the stock price is overvalued by the market

Recommendations

Eaton Corporation has been a successful industrial manufacturer for many years and continues to be an industry leader in terms of profitability and growth. For this reason, it is difficult to offer recommendations in regards to their capital structure. Therefore, it is suggested that they stay the course and continue to fund investment needs internally. If any suggestion were warranted, it would be for Eaton to change their debt

policy to become more leveraged. This would allow them to utilize the tax advantages of borrowing by protecting their cash flows.

We can now discuss the three technology companies as a group and analyze its capital structure.

Technology Industry Overview

The technology industry has been rapidly growing over the last few decades. It has made leaps and bounds in expansion and growth. The three companies that were analyzed and compared were Snap-On Tools, Eaton Corporation, and Stanley Works. All three companies have made a name for themselves in the industry. They have all established their sales and staying ability. They also have many similar features when it comes to capital structure and stock price evaluation.

Capital Structure of Technology Firms

When comparing the current capital structure of the three companies in technology industry, they are all operating below their optimal level of capital structure. All three companies cost of debt is low. This means that they are focusing financing needs through internal funding. This is a typical industry pattern across the world. More profitable industries tend to fund their projects with internal cash flows and with their retained earnings. These statistics look great as long as the companies are not missing some savings by leaning away from external financing. One of the major benefits of external financing is the low cost of using it. Debt financing is substantially cheaper than

issuing stock. This means that these companies could benefit by financing some upcoming projects through external creditors. One has to be careful in deciding to increase the leverage as it may increase the financial distress thereby lowering the stock price. Hence, managers tend to use the financial slack as much as possible before venturing into external funding. By looking at the combined graph (See Appendix 13) for Beta, COE, COD and WACC for all the three companies and the average value of these companies, we can see that there is not much variation in their values. This may be due to the fact that they all are diversified industries serving a larger consumer base and are pretty much of the same size. Had we picked a company like General Motors and compare it to a medium sized company, the graph will look different and there will be lots of differences in their Beta values as well. The prime reason for this might be due to the financial status of the company and how market reacts to its new initiatives.

The Cost of Equity for all three technology companies is below the optimal level which could indicate that they are not reinvesting funds to generate additional earnings properly. They could be utilizing stock to raise their stock prices and fund projects that they may be passing up because of lack of capital.

The Debt to Assets ratio for all three companies are considerably below the optimal levels of capital structure, but the percentage is less than 50 percent which a good indication that the companies are not overusing their leverage. To improve this ratio all three companies may want to increase the value of the assets that they currently have.

The Cost of Debt for all three companies is all low which means that they are not reliant on debt financing. This fact lowers the risk that these companies will go under. They appear more stable.

The weighted average cost of capital for all three technology companies is close to their optimal level. This is a good sign that the companies are on the correct paths to raising stock prices and continuing to great success.

Stock Price Discussion

The stock price comparison of the technology companies seems to show that the technology companies may be undervalued. All three companies could benefit from raising their stock prices. Reinvesting their earnings in different higher return projects could help maximize shareholder wealth. Per the pecking order hypothesis, managers tend to issue equities when they think the price is overvalued and tend to issue debt when the price is undervalued. This situation is easily caught by the market and hence managers should provide the correct "signals", using the signal modeling process, to the market in order to effectively raise their stock prices.

Recommendations

For Eaton Corporation, the recommendation would be to stay their course of action. The only suggestion would be for them to rethink their debt policy. For Snap-On International, the recommendation would be financing new projects through external sources. This would put them in a better financial situation. They would be less likely to avoid a hostile takeover. For Stanley Works, they should focus their efforts on finding the ideal combination of debt and equity financing with more emphasis on external sources. They should also focus on raising their stock price.

We will turn our discussion of capital structure for Food Industry. The following section discusses the financial conditions of McDonald's, Wendy's and Sonic Corporation.

Food Industry

McDonald's Corporation

McDonald's Corporation has been one of the leading fast food restaurants in the world for many years. They have managed to successfully dominate the fast food market. According to McDonald's website, their sales exceeded $20 billion in 2005. They have locations in over 100 different countries. Their philosophy has been customer-focused. In order to calculate the capital structure, data was taken directly from McDonald's website in their financial reports from 2005 and previous years. From the website, enough data was taken to calculate the current and optimal capital structures below.

Current Capital Structure

D/(D+E)	Beta	Cost of Equity	Cost of Debt	WACC
22.51%	0.98	10.49%	4.88%	9.23%

Optimal Capital Structure

D/(D+E)	Beta	Cost of Equity	Cost of Debt	WACC
20.00%	0.95	10.33%	4.88%	9.24%

Capital Structure Discussion

McDonald's current and optimal capital structures are almost identical. They are operating efficiently and effectively worldwide. They have been undergoing a restructuring primarily in the international markets. This restructuring seems to be increasing their growth. Their cost of equity and debt is slightly above the optimal level, but the cost of debt and weighted average of cost of capital is almost exactly at optimal level. Their debt ratio is a little high when compared to the optimal. They may want to focus on bringing down that ratio to the optimal level by raising total equity slightly. However, this may cause other problems in other areas and ratios. At this point, management needs to continue to focus their efforts as they have been. They may try to focus on adding value to the assets that they already have or paying off some of their debt. They may want to reevaluate when they finish their restructuring.

Stock Price Discussion

McDonald's stock price at year-end 2005 was $33.72. According to the calculations, McDonald's Gordon Growth Model is -$18.02. This means that the company's growth rate is exceeding their cost of equity. The stock price using intrinsic valuation is $34.55. The stock price when looking at Free Cash Flow is $8.91. Looking at all the calculations leads us to believe that McDonald's stock price is almost exactly where it should be. When looking at the Free Cash Flow, the stock price might be considered overvalued because the price per share after debt and other obligations is not close to the actual stock price.

Recommendations

McDonald's has been a successful retailer of fast food for many years and will continue to be an industry leader in terms of profitability and growth for many more years. This alone makes it difficult to offer recommendations in regards to their capital structure. They need to continue down their current path and structure. They are in the process of restructuring, so they may want to reevaluate after the restructuring years have passed. The only recommendation might be to lower their cost of equity minimally. They also need to level out their debt to equity/assets calculations. In order to lower their cost of equity, they need to reevaluate how they are investing their equity financing in projects, research, and development. They will also need to reevaluate when they finish with their restructuring.

Wendy's

Wendy's Old Fashioned Hamburgers, owned by Wendy's International, is the third largest quick-service hamburger restaurant chain in the world, with more than 6,700 restaurants in North America and international markets. Founded by Dave Thomas in 1969, Wendy's serves hamburgers made with fresh beef hot-off-the-grill and a choice of toppings. They also serve chicken sandwiches, fries, Frosty deserts, soft drinks, and a variety of fresh, healthful foods - garden salads, grilled chicken sandwiches, baked potatoes, and chili.

Current Capital Structure

D/(D+E)	Beta	Cost of Equity	Cost of Debt	WACC
11.43%	0.89	9.98%	2.80%	9.16%

Optimal Capital Structure

D/(D+E)	Beta	Cost of Equity	Cost of Debt	WACC
30.00%	1.02	10.72%	3.66%	8.60%

Capital Structure Discussion

Information for Wendy's was compiled from a variety of sources, namely Yahoo Financials, for balance sheet and income statement information, and SEC Form 10-K filings as found in the EDGAR database, for operating lease information. As evidenced by the financial analysis in this report, Wendy's International is deviating significantly from its optimal capital structure primarily in its debt ratio. The financial management decision to not leverage the company with more debt is driving up the weighted average cost of capital (or WACC) from an optimal rate of 8.60% at a 30% debt ratio to 9.16% at its current debt ratio of 11.43%. To understand the reasons for why Wendy's is not fully utilizing it's debt potential, we must consider several key industry concerns, such as research and development efficiency and potential substitute goods, earnings volatility (fluctuating sales and profits), the applications of sophisticated products or intangible goods, political and social unrest, market backlash, and competitive advantage.

As a fast-food establishment serving products requiring little or no product research and development effort, we can eliminate R&D efficiency from the potential candidates of factors affecting the deviation from an optimal capital structure. The firm operates in very competitive market, where many substitutes for its products exist, both among national competitors with homogenous products, and local eating establishments that compete with individual stores on a smaller scale. Wendy's has some earnings

volatility, though most changes in dividends have been steady, but large growth periods, at 61.65% from the period of 2003 to the end of 2005. The firm has no sophisticated products or intangible goods that significantly impact financial decisions, and despite the notorious incident of Anna Ayala making national attention by claiming a portion of a finger was served to her in a Wendy's meal, causing drops in same-store sales in Q2 and Q3 of 2005, a sustained market backlash has not occurred nor significantly affected Wendy's annual numbers or capital structure decisions.

What then, could be causing the firm to make the financial decisions it has? One consideration is entrenched management. In 1997, Berger, Ofek, and Yermack surveyed 423 Forbes firms and determined entrenchment by management to be a leading cause of the underutilization of debt in capital structuring. However, a survey of the tenure of officers at Wendy's International finds the majority of its officers have served at their current level of responsibility five years or less. In 1997, S. C. Myers suggested high growth firms may pass up valuable projects if benefits primarily accrue to bondholders, suggesting that high growth firms use less debt. This would appear to coincide with the financial statistics accumulated in this financial analysis, where gross revenue increased 20% from 2004 to 2006, and gross profit increased at 9.4% over the same period.

Stock Price Discussion

However, a per-share stock price analysis in the Gordon Growth Model form of $P_0 = D_0 / (r - g)$, given Wendy's 2005's dividend payout of $66,137,000 and considering a 10.6% market return rate (5% risk free rate plus the 5.6% risk premium) with a sustained growth rate of 8.31% yields a suggested share price of $24.99 per share. The Gordon Growth Model within the Excel file itself which uses a higher cost of equity

(currently 11.22%) estimates the stock share price at $37.01. This still falls considerably short of the $59.66 / share the stock commands in the open market, which does not seem justified given the analysis. Therefore, we conclude the stock is overvalued by the market.

Recommendations

Given its strong, sustained rate of growth, we recommend that Wendy's International should continue to buy back shares at a moderate pace and seek external finances from debt instruments instead of equity issuance in the middle-term future. Reducing shares outstanding lowers the dividend Wendy's needs to declare for its shareholders, improving its capital retention rate and internal financing capacity. Revising its capital structure to increase financial leverage will lower its weighted average cost of capital (WACC), potentially increasing net profit available to common shareholders as less is spent for external financing. While managers may be resistant to make decisions which will primarily benefit bondholders, this decision would also increase shareholder value as the firm pays less to acquire new capital. This decision should not only serve to bring Wendy's capital structure into optimal ranges, it should increase shareholder wealth and help this strong, expanding chain compete more efficiently in its industry.

Sonic

Sonic is a large fast food type of restaurant chain with more than 3200 units through out the United States. Sonic has been very famous for their different menu items and their slushes and drinks are the best among the industry standards. The financial data

for Sonic were obtained from their website as well as from Yahoo Financials. The following tables compare Sonic's current capital structure with the optimal values.

Current Capital Structure

D/(D+E)	Beta	Cost of Equity	Cost of Debt	WACC
4.50%	0.60	8.36%	3.36%	8.14%

Optimal Capital Structure

D/(D+E)	Beta	Cost of Equity	Cost of Debt	WACC
20.00%	0.67	8.78%	4.08%	7.84%

Capital Structure Discussion

The results show some amount of differences in the current capital structure versus the optimal capital structure for debt-to-equity (D/(D+E)), while the company's current cost of debt and weighted average cost of capital (WACC) and the cost of equity indicate that they are operating at more or less at optimal conditions. This indicates that Sonic follows the industry standards for most of the important terms. It looks like Sonic uses most of their internal cash for funding the operations and can be seen from the D/(D+E) numbers. This condition may be advisable for most fast food industries like Wendy's and McDonalds and we will compare this with the other two industries when we do the consolidated comparison. The current beta of 0.60 indicates that Sonic may be encouraging investors by showing that their stock prices may not be heavily affected by market volatility. In the current case, if the stock market increases by one percent, then the price of Sonic stock would increase by only 0.60 percent. The optimal Beta of 0.67, for such an industry is pretty close to what sonic operates According to Pecking Order

hypothesis; debt ratios and profitability are inversely related. If a firm is profitable, it does not need to borrow money to capture any tax advantages of debt (*Corporate Finance*, Smart, Megginson, Gitman). This appears to be the philosophy of Sonic. They are so profitable that they can provide internal resources for research and development, capital investments, and other needs. It should be noted however, that they do have a D/(D+E) of 4.5 percent and that the current cost of debt is 3.36 percent, which is almost optimal.

Stock Price

The current market price of Sonic stock is about $22.13. Price using the intrinsic valuation is $5.90. Gordon Growth model cannot be used because Sonic does not pay dividends. When compared to intrinsic valuation, Sonic's stock is overpriced. Sonic funds its operations through internal cash flows and hence does not use a lot of debts for its operations. It can increase its leverage thereby increasing its intrinsic stock valuation. One would not want to deliberately reduce the market price of the stock.

Recommendations

Sonic has been a successful so far and continues to be at par with industry standards terms of profitability and growth. One possible recommendation would be to use its financial leverages and increase the intrinsic value of their stock prices thereby providing a better outlook of the company for investors. This may further increase their market price of stock and also help in reducing the use of internal cash flows for supporting their operations. Otherwise, they just have to continue doing the good job and expand their operations as per the financial planning.

Food Industry Overview

So far we have discussed about the three fast food industries and their financial structure. The following section will discuss the combination of all three food chains. A graphical representation of the various financial characteristics is shown in Appendix 14. Sampling these three firms, industry costs of equity seem to be moderate, around 10%, and costs of debt seem to be relatively low, around 4%. Costs of debt are likely low for this industry because most firms on a national or global scale have cash flows sufficient to fund the majority of expansions, capital improvements, and other projects internally. Their large asset base and moderate financial leverage (around 10-20%) gives them an advantage in the market when selling debt, improving their bond rating, and therefore their cost of debt. Betas seem to be correlated to market capitalization, as Sonic, a smaller firm, has a relatively low beta compared to national and global players McDonald's and Wendy's. This is likely because large firms diversify their systematic business risk through multiple lines of business serving different market or product segments. For instance, McDonald's also owns the Boston Market chain of restaurants, and Wendy's International owns Baja Fresh, a Mexican food chain in the western United States. Holding these other lines of business allows larger fast-food industry players to provide offerings that attract multiple market segments and also makes them more resilient to medium-term social changes, such as a shift in preference away from fast-food burger chains.

Conclusion

In conclusion, the principles of financial management apply equally to all firms in all industries. However, specific financial management practices, including decisions about capital structuring and financial leverage may vary by industry depending on the specific characteristics of that industry. Specifically, an optimal capital structuring model generalized to apply to all firms will fail to take into account all factors affecting profitability and long-term shareholder value. Therefore, it is important for financial managers to understand the importance of optimal capital structuring models and yet understand their relevance of applicability given the industry in which they operate.