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Repacking a Global Brand: A Case Study Analyzing the Capital Expenditure Decision

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INTRODUCTION

It is early 2014. A leading global skincare manufacturer, Health & Beauty Co. (HBC), has been losing market share in the hand and body lotion market. While the firm still leads its competitors in market share in this segment of personal care, it seeks to stem further share erosion and, to that end, has recently developed a strategy to recover market share through rebranding, advertising, and repackaging. The situation is especially critical since a large competitor is believed to be launching a new skincare product in the near future.

Your task as senior financial analyst is to draft the capital expenditure proposal related to the new packaging proposal. Information to support you in this task follows. You should complete the firm's capital expenditure template included in Appendix 1.

BACKGROUND:

The U.S. skincare market has been growing at an average rate of 4% over the past three years and is estimated to reach $11 billion in 2018. This market includes facial, body, and hair care, as well as other makeup segments. HBC holds a leadership position in the hand and body lotion market but needs to evolve to meet consumers' growing needs and compete with an ever-increasing number of competitors. Recent market research by HBC revealed that consumers perceive the current packaging as outdated: old, generic, dull, and cheap looking. It also lacks a contemporary and premium look compared with some of the main competitor's products. HBC is in the process of rebranding these product lines, and newly developed packaging will play a pivotal role in the plan to rebrand and reposition the product. The new packaging aims to convey the brand image of modern, up-to-date, high-quality, everyday use, and good value.

Preliminary investigation comparing the existing and proposed packaging revealed the following:

1. The proposed packaging will keep the brand fresh and relevant while maintaining the brand heritage and appeal to existing and future consumers.
2. The project:
   a. Provides the opportunity to simplify an over-complicated and confusing pack line-up by reducing the current portfolio of sizes.
   b. May lead to improved margins since there is the potential to raise prices on the newly packaged items. The current gross margin of the product is 69%.
3. Overall, the new pack design is a cost-effective pack with package unit prices lower than that of the current brand pack.
4. The brand team believes that incremental sales growth is achievable through the combination of new brand positioning, advertising, and packaging. Feedback from several large retailers consulted on the new packaging was consistently positive.

PROJECT INFORMATION:

The new packaging would require the purchase of molds and assembly equipment (useful life of six years on all) as follows:

Cap/Pump molds	$1,590,000
Change part	260,000
Pump assembly	570,000

In addition, the firm will incur start-up expenses related to partial case returns and other items. It is assumed that major customers will be able to manage down their inventory levels with the assistance of the transitions team. Minimal returns will come from large retailers including WalMart and Kmart due to their quick inventory turnover. It is anticipated that most returns will come from drug retailers as they shift products to the new packaging and remove unsold product from the shelves.

Partial case returns net of salvage value	$1,800,000
Label conversion costs	700,000
Freight charge/launch year expenses	400,000
Other miscellaneous	300,000

The redesign calls for cutting SKU's from 79 to 49. No volume loss is anticipated from this since the transition team will actively manage shelf space on a customer-by-customer basis to minimize loss of shelf presence. The SKU reduction is estimated at $119,000 per year since the new package design is less expensive per unit.

The brand's current long-term strategic role is to maintain share and grow at category levels. Sales in the most recent year were $139.5 million. Without the redesign, sales are forecast to remain flat at historic levels. With the redesign, management believes that sales can grow at the rate of the skincare category—forecast at 4% per year for the next five years—and there will also be incremental growth related to recovery of market share of 2% in Year 1, 1% in Year 2, 0.5% in Year 3, and 0% thereafter.

The gross margin will remain at 69% of net sales. The incremental marketing and development cost is a one-time $700,000 for market research and development. Management thought the project should be evaluated using a discount rate of 7% based on the firm's weighted average cost of capital (WACC) and the perceived riskiness of the project. The tax rate is 27%.

ASSIGNMENT QUESTION:

1. As the accounting financial analyst supporting the brand, the CFO assigns you the project of completing a capital expenditure proposal for the repackaging. You must complete the template in Appendix 1.

Appendix 1. Capital Expenditure Proposal Template

(This form should be used for the approval of capital expenditures costing greater than $1,000 with a useful life of more than one year that are capitalized on the balance sheet as fixed assets.)

Capital Expenditure Proposal

Section 1: Background
Describe here the project background, description, timeline, strategic rationale, and expected impact.

Section 2: Financial analysis
Identify and calculate the key metrics that will be used to analyze the decision. This might include proforma financials, NPV, IRR, Payback, ROIC, break-even, and/or other measures.

Section 3: Risks

Outline the financial and nonfinancial risks associated with the project.

Analyze the impact of the risks outlined above through sensitivity and scenario analyses. You should include tables summarizing the results.

Section 4: Ethical considerations

Identify ethics issues of repackaging/rebranding a product without improving it. Also, consider if it is ethical to increase the price without improving the product.