ONLINE SIMULATION FOREGROUND READING

Finance: Capital Budgeting

Company and Industry Overview

The New Heritage Doll Company, based in Sacramento, California, was a privately held company with 450 employees and approximately $245 million in fiscal 2009 revenues. This represented approximately 8% of the $3.1 billion U.S. doll industry, which was projected to grow by 2% annually to $3.4 billion in retail sales by 2013. In turn, the doll industry represented a 7.4% share of the total $42 billion U.S. market for toys and games, which was dominated by global enterprises that enjoyed economies of scale in design, production, and distribution. Revenues were highly seasonal; the largest selling season in the United States coincided with the winter holiday period.

The doll category included large, soft, and mini dolls, as well as doll clothes and other accessories. The phenomenon of “age compression”—the tendency of younger children to prefer dolls that had traditionally been designed for older girls—reduced growth in the “baby-doll” sub-segment. Competition among doll producers was vigorous, as a small number of large producers targeted similar demographics and marketed their dolls through the same media. Lasting franchise value for a branded line of dolls was rare; the enormous success of Barbie® dolls was an obvious exception. More recently and on a much smaller scale, New Heritage also had created a durable franchise for its line of heirloom dolls. However, the popularity of most doll lines waned after a few years.

New Heritage’s Production Division

New Heritage Doll Co. had three operating divisions: a doll and doll-accessory production division, a retailing division, and a licensing division. New Heritage’s doll production division designed and assembled dolls, doll accessories, and children’s accessories into finished product and then packaged them for shipment. The production division generated $125 million in revenue and $7.5 million in operating profit a year.¹ Seventy-five percent of its sales were internal, to New Heritage’s retail division; 25% of its revenues were generated from private-label goods manufactured for other firms. The dolls ranged from relatively inexpensive baby dolls ($15 to $30 retail price range) to fashion dolls modeled after movie stars that were targeted as upscale collectors’ items ($75

¹ The division revenue figures include approximately $95 million of internal sales within divisions which are eliminated when considering consolidated revenue for the company.
to $150 range) for the “tween” (ages 8 to 12) demographic. Doll accessories, which made up 15% of the division’s total revenue, included doll clothing and “doll gear” to mimic real-life situations in which the doll “character” might find herself (camping gear, sports gear, etc.).

Similar to other U.S. toy manufacturers, a large portion of New Heritage’s assembly and packaging was done overseas, in China and Taiwan, using components manufactured by third-party vendors. However, manufacturing activities that required precise tolerances or proprietary processes, along with all the creative functions (concept testing, product design, and product-prototype development) were handled in-house at the company’s headquarters facilities in Sacramento.

**New Heritage’s Retail Division**

The second division of New Heritage Doll Company was the retail division, which generated $190 million of New Heritage’s revenue and $4.8 million in operating profit. The retail division managed the sale of the dolls and accessories that the production division designed, assembled and packaged. The retail division sold its merchandise through three channels: a website (42%), a mail-order paper catalog (33%), and a network of retail stores (25%). In addition to selling merchandise online, the internet home page offered membership clubs that girls could join, organized around favorite doll characters, and “doll and girl” fashion newsletters to which girls could subscribe. The paper catalog sales were declining, but it was still an important distribution channel for New Heritage Doll Company.

New Heritage Doll Company owned and operated 32 retail stores, each generating average annual revenues of $1.5 million. Stores were located in major metropolitan areas throughout the United States and Canada. The two California stores in Sacramento and San Francisco were the flagships. These stores were followed by openings along the West Coast, in the Southwest, and in the Midwest. The South had been a recent area of expansion, with the company building out its retail presence in northern Florida, Georgia, and the Carolinas. However, the company did not yet have a major presence in the Northeast. Each store, described as an “experiential destination,” was architecturally designed so that girls and parents felt that they were visiting and spending a day with their favorite doll characters. One part of each store was designed for the families of toddlers and the other for the tween demographic. Each store offered various activities and entertainment to entice the families to stay longer, such as a café, a doll “hair salon,” and rooms to rent for private parties.

**New Heritage’s Licensing Division**

The third and last division of New Heritage Doll Company was the media licensing division, which generated annual revenues of $24.5 million and $14.5 million in operating profit. It licensed the rights to New Heritage’s branded doll characters and story lines (such as “Jodie, the Sunny Valley Girl”) to media publishing companies for use in books, software, movies, and other products featuring the NH-branded doll characters. NH licensed the rights to use its doll characters to licensees whose quality standards and demographic reach matched NH’s target consumers well. NH’s well-recognized doll characters had such brand value that NH was able to strike advantageous deals with licensees. The licensing division generated $5 million annually from licensing agreements with book publishers; $2.5 million from software and video licenses; $12 million from movie and TV licenses; and $5 million from other miscellaneous licensing agreements. Generally the company tried
to negotiate agreements in which it received greater than 50% of the net product revenue. The media licensing strategy reduced the ongoing advertising and marketing spend requirements for individual doll brands and generally made the dolls more popular among consumers.

**New Heritage’s Corporate Strategy**

New Heritage’s CEO considered the company’s distinctive skill to be its management of the creative process in each of its divisions. The company’s overriding strategic goal was to build and grow customer identification with its doll characters in various forms of product and entertainment through all stages of a child’s life, from toddlerhood through the teenage years. To achieve this goal, the CEO encouraged expansive and innovative ideas and was very protective of the creative process. However, she was also very clear that businesses were expected to meet financial objectives.

The product division’s long-term strategy involved building on its core expertise in doll and accessory design and development in order to expand and deepen its offerings to two key demographic customer segments—toddler/young girls and tweens—each of which offered various opportunities for growth. New Heritage’s retail division strategy was to expand geographically within the United States across all three channels. In the United States, the company planned to continue to invest in its “retail as entertainment” concept through store expansion. However, Asia and Europe were also considered strategic markets as the company sought to grow its international revenue. The strategy of the licensing division was to continue to grow revenue derived from New Heritage’s core branded assets, but to do so in a reasonable way. The company recognized that as it entered new business opportunities it increasingly faced the prospect of damaging its core doll brands.

The biggest management and strategic challenge for the company related to coordination of activities among the three divisions. The company negotiated internal transfer prices for activity performed by one division for another. However, initiatives and campaigns in one division needed to be carefully coordinated with those in other divisions if the company was to successfully leverage its doll character brands across all divisions.

**The Capital Budgeting Process at New Heritage**

The annual investment process at New Heritage began with personnel in each division proposing projects for investment that were aligned with the company’s multi-year strategy plans. As the company grew, deliberate steps were taken to decentralize some of the project approval process and increase spending authority at the division level. However, large and/or strategic spending proposals were reviewed at the corporate level by a capital budgeting committee consisting of the CEO, CFO, COO, the controller, and the division presidents.

Each project proposal presented to the committee included the following information: brief description of the project and the strategic rationale; overview base case financials (five-year operating and cash flow forecasts); spending requirements by asset category, personnel requirements, key project financial performance measures (NPV, IRR, payback period, profitability index); and project risks and milestones. Proposed projects ran the gamut from relatively minor, tactical projects (the replacement of obsolete assembly equipment) to major strategic projects that would significantly alter the company’s market position (an acquisition, for example). Some projects were
interdependent across the spectrum of investment opportunities; others were exclusive. Many extended over a multi-period time horizon and involved a high degree of uncertainty.

New Heritage’s corporate cost of capital was 7.7%. However, New Heritage assigned discount rates to projects according to a subjective assessment of each project’s risk. High-, medium-, and low-risk categories for each division were associated with a corresponding discount rate set by the capital budgeting committee in consultation with the corporate treasurer. Assessments of each project’s risk were made at the division level, but subject to review by the capital committee. Factors considered in the assessment of a project’s risk included, for example, whether it required new consumer acceptance or new technology, high levels of fixed costs and hence high breakeven production volumes, the sensitivity of price or volume to macroeconomic recession, the anticipated degree of price competition, and so forth. For example, in 2010, “medium”-risk projects in the production division received a discount rate of 8.4%. High- and low-risk projects were assessed at 9.0% and 7.7%, respectively.

Projects that created value indefinitely, given continuing investment, were treated as going concerns with a perpetual life. That is, NPV calculations included a terminal value computed as the value of a perpetuity growing at a constant rate. However, to preserve an element of conservatism, the capital committee generally insisted on relatively low perpetual growth rates – lower than New Heritage’s historical growth and lower than near-term growth forecasts for a given division.

The committee examined projects for consistency with New Heritage’s business strategy and sought to balance the needs and priorities of each division against practical financial and organizational constraints. The committee also sought to understand project interdependencies and the potential for a given investment to strengthen the whole company, not solely the division proposing it.

**Simulation Game Play**

As the CEO and the head of New Heritage’s capital committee, you will decide which projects should be funded for implementation. The board of directors sets an annual limit on dollar funding for capital projects. This limit was generally a function of the firm’s internal resources, its ability to raise additional capital, and organizational constraints. Often, the total amount of funds committed to internal investments in a given year also depended on most recent operating results – higher profitability could lead to higher capital spending. (Acquisitions and very large investments were funded “off-budget” for example, by the issuance of additional corporate debt.) The company’s managers proposed more projects for consideration than could be funded. As a result, some value-creating projects would be rejected due to the limit on available capital. It was therefore necessary for the capital committee to select the best set of investments from the pool of available options in any given fiscal year.

Given the limits on available capital at New Heritage, you will be unable to invest in all proposals, even if they are value-creating and exceed risk-adjusted hurdle rates. Your task is to evaluate proposed projects using the financial and qualitative information provided and to select projects to be approved for a given year’s investment plan using any evaluation criteria you deem appropriate. You will be required to monitor your selected investments, evaluate new investment proposals, and submit annual capital plans over a period of five years, from 2010 through 2014.