Question 2

A Company has two manufacturing units: Parts and Photocopiers. It has been manufacturing and selling parts for large format printers and photocopiers for a number of years. The company started manufacturing and selling its own brand of photocopiers a few years ago. The parts manufacturing unit accounts for around 80% of the company's business in terms of sales revenue, non-current and current assets, and payables. However, it is estimated that this business unit accounts for around 75% of the company's operating costs. The smaller photocopier manufacturing unit accounts for the remaining 20% of sales revenue, non-current and current assets, and payables; and around 25% of the company's operating costs.

The following figures have been extracted from the company's most recent financial statements:

	$m
Sales Revenue	16,800
Operating costs	(10,080)
Profit before depreciation, interest and tax	6,720
Non-Current Assets	
Land and Buildings	7,500
Equipment	5,400
Non- Current Liabilities	
Bank loan 4.5%	1800
Current liabilities	
Payables	750

After limited initial success, competition in the photocopier market has become very tough with falling revenue and profits and so management is considering selling off that unit of the business.

The smaller photocopier manufacturing unit will be unbundled through a management buy-out by four managers. If this is successful, it is estimated that its after-tax net cash

flows will increase by 8% in the first year only and then stay fixed at this level for the foreseeable future. The cost of capital related to the smaller business unit is estimated to be 10%. The company pays tax at 18% on its profits and it can be assumed that tax is payable in the year incurred. All the non-current assets are eligible for tax allowable depreciation of 12% annually on the book values. The annual reinvestment needed to keep operations at their current levels is equivalent to the tax allowable depreciation.

The management buy-out team is expected to pay the company 70% of the estimated market value of the smaller photocopier business unit.

Required

Estimate the amount payable to the company by the MBO team.

VALAUATIONS 2 UNBUNDLING Question 2

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After limited initial success, competition in the photocopier market has become very tough with falling revenue and profits and so management is considering unbundling that unit of the business. It is expected that the assets of this smaller unit will be sold to a competitor for $3,102m after its share of payables has been paid.

The company will then invest $1,200m into the parts manufacturing unit and this will result in profits and cash flows growing by 4% per year in perpetuity.

Additional financial information:

The company aims to maintain a long-term capital structure of 20% debt and 80% equity in market value terms following the sale of the smaller unit. The company's finance director has assessed that the 4·50% annual interest on its bank loan is a reasonable estimate of its long-term cost of debt, based on the long-term capital structure above. Although the company does not know what its cost of capital is for the parts business unit, its finance director has determined that the current ungeared cost of equity of Kapito Co, a large quoted company involved in manufacturing similar parts mainly for exports, is 12·46%. The company's finance director wants to use Kapito Co's ungeared cost of equity to calculate its cost of capital for the parts manufacturing business unit.

The annual corporation tax rate on profits applicable to all companies is 18% and it can be assumed that tax is payable in the year incurred. All the non-current assets are eligible for tax allowable depreciation of 12% annually on the book values. The annual reinvestment needed to keep operations at their current levels is equivalent to the tax allowable depreciation.

Required

Estimate the value of equity of the Parts manufacturing unit after the sale the photocopier manufacturing unit.

SHARE FOR SHARE EXCHANGE

Pinto Co is a listed company producing office furniture which it sells around the world. It wants to acquire Tornton Co, an unlisted company producing high quality, luxury garden furniture. Pinto Co proposes to pay for the acquisition using one of the following three methods:

- Method 1 A cash offer of $5·00 per Tornton Co share; or
- Method 2 An offer of three of its shares for two of Tornton Co's shares; or
- Method 3 An offer of a 2% coupon bond in exchange for 16 Tornton Co's shares. The bond will be redeemed in three years at its par value of $100.

Extracts from the latest financial statements of both companies are as follows:

	Pinto Co	Tornton Co
	$'000	$'000
Sales Revenue	44,210	4,680
Profit before tax	6,190	780
Taxation	(1,240)	(155)
Profit after Tax	4,950	625
Non-current liabilities	9,700	873
Share capital (40c per share)	4,400	500

Pinto Co's current share price is $3·60 per share and it has estimated that Tornton Co's price to earnings ratio is 12·5% higher than Pinto Co's current price to earnings ratio. Pinto Co's non-current liabilities include a 6% bond redeemable in three years at par which is currently trading at $104 per $100 par value.

Pinto Co estimates that it could achieve synergy savings of 30% of Tornton Co's estimated equity value by eliminating duplicated administrative functions, selling excess non-current assets and through reducing the workforce numbers, if the acquisition were successful.

Required:

Estimate the percentage gain on a Tornton Co share under each of the above three payment methods. Comment on the answers obtained.