VALUATIONS + ACQUISITIONS AND MERGERS

Question 1

A company has 263 million shares in issue and the current market value of its debt is $400 million. Its most recent profit before interest and tax was $132·0 million, after deducting tax allowable depreciation and non-cash expenses of $27·4 million. The company makes an annual cash investment of $24·3 million in non-current assets and working capital. It is estimated that its cash flows will grow by 3% annually for the foreseeable future. The company's current cost of capital is estimated to be 11% and pays tax at 20% on profits.

Required:

Estimate the equity value per share of the company.

ESTIMATING COMBINED EQUITY VALUE – FREE CASH FLOW TO THE FIRM

Question 2

Company A is looking forward to acquiring company B. If Company A acquires company B, it is expected that the combined company's sales revenue will be $7,351 million in the first year and its annual pre-tax profit margin on sales will be 15·4% for the foreseeable future. After the first year, sales revenue will grow by 5·02% every year for the next three years. It can be assumed that the combined company's annual depreciation will be equivalent to the investment required to maintain the company at current operational levels. However, in order to increase the sales revenue levels each year, the combined company will require an additional investment of $109 million in the first year and $0·31 for every $1 increase in sales revenue for each of the next three years. After the first four years, it is expected that the combined company's free cash flows will grow by 2·4% annually for the foreseeable future. The combined company's cost of capital is estimated to be 10%.

It expected that the combined company's debt to equity level will be maintained at 40:60, in market value terms, after the acquisition has taken place. Both companies pay corporation tax on profits at an annual rate of 20% and it is expected that this rate will not change if Company A acquires Company B. It can be assumed that corporation tax is payable in the same year as the profits it is charged on.

Required:

Estimate the equity value of the combined company.

ESTIMATING COMBINED COST OF CAPITAL IN MERGERS AND ACQUISITIONS

Estimating the combined company's weighted average cost of capital

Kikat Co is of the opinion that as a result of acquiring Zooky Co, the cost of capital will be based on the equity beta and the cost of debt of the combined company. The asset beta of the combined company is the individual companies' asset betas weighted in proportion of the individual companies' market value of equity. Kikat Co has a market debt to equity ratio of 40:60 and an equity beta of 1·10. It can be assumed that the proportion of market value of debt to market value of equity will be maintained after the two companies combine.

Currently, Kikat Co's total firm value (market values of debt and equity combined) is $60,000 million and Zooky Co's asset beta is 0·68.

Additional information

- The estimate of the risk free rate of return is 4·3% and of the market risk premium is 7%.
- The corporation tax rate applicable to all companies is 22%.
- Zooky Co's current share price is $3 per share and has a total 7000 shares in issue.
- The pre-tax cost of debt of the combined company is expected to be 6.0%.

Required

Estimate the combined cost of capital post-acquisition