

11. Corporate Restructuring. Corporate Control. Mergers & Acquisitions

Problem 67

You have been asked to advise on a management buy-out project. The buy-out will cost a total of \$10 million of which 80% will be financed by a 12% fixed rate loan, and 20% by \$1 common shares. Half of the ordinary shares would be sold to the buy-out team at par, the other half to a venture capitalist also at par. The venture capitalist's shares have warrants attached, which permit the purchase of an equal amount of common shares at par any time up to five years in the future. The 12% loan would be repayable over a period of three years in equal annual installments comprising both interest and principal. The annual payment is \$3,331 million. The buy-out team is also responsible to service an existing \$2 million 10% loan which is due to mature in ten years. No dividends are expected to be paid during the next three years. The current earnings before interest and tax are \$1,0 million, and the income tax rate is 20% per annum. If the buy-out occurs, the expected growth in EBIT is 5% per year for up to three years without additional capex.

The management buy-out team hopes to achieve a listing on the Warsaw Stock Exchange in three years' time. They have been told that a successful WSE issue is likely to require a book value capital gearing level of not more than 60% D/E.

(a) Advise the buy-out team whether or not the SIPO is likely to be realized.

(b) Calculate a reasonable price of one share that might be expected after three years.

Solution

(a)

Year	0	1	2	3
New debt	8,000	5,629	2,974	0,000
Loan payment		3,331	3,331	3,331
Principal		2,371	2,655	2,974
Interest		0,960	0,676	0,357
Existing debt	2,000	2,000	2,000	2,000
Interest		0,200	0,200	0,200
Total interest		1,160	0,876	0,557
Earnings before interest and tax		1,050	1,103	1,158
Taxable income		-0,110	0,227	0,601
Tax		0	0,0454	0,12015
Retained		-0,110	0,182	0,481

Equity, debt and gearing when warrants are not exercised.

Year	0	1	2	3
Book value of equity	2,000	1,890	2,072	2,552
Book value of debt	10,000	7,629	4,974	2,000
Gearing	500%	404%	240%	78%

The book value gearing after three years is estimated to be 78%.

Equity, debt and gearing when warrants are exercised.

Book value of equity	3,000	2,890	3,072	3,552
Book value of debt	10,000	7,629	4,974	2,000
Gearing	333%	264%	162%	56%

Equity would increase by \$1 million, and the gearing would fall to 56%.

(b)

The book value of equity 3,552 divided by the number of shares is

1,184

Problem 68

The Pepper Co. wishes to acquire the Salt Co. The shares outstanding, share prices and earnings are as follows:

Company	Outstanding Shares	Share Price (\$)	Earnings (\$)
Pepper	1 000 000	100	5 000 000
Salt	200 000	25	500 000

Pepper is considering three different acquisition plans:

1. Pay \$30 per share for each Salt share.
2. Trade \$120 cash and one new Pepper share for every eight Salt shares.
3. Trade one new Pepper share for every four Salt shares.

- (a) What are the two companies' EPS, P/E ratios and market values today?
 (b) What will Pepper's EPS be under each of the three plans?
 (c) If Pepper's P-E ratio remains what it is today, what will the share price be under each of the three plans? What will be the Pepper's market value? What will be the breakdown of the merger benefits between the current shareholders of each company?
 (d) Redo part (c), assuming that the postmerger P/E ratio is 25.
 (e) Redo part (c), assuming that the postmerger P/E ratio is 15.

Solution

(a)

	EPS	P/E	V
Pepper	5	20	100 000 000
Salt	2,5	10	5 000 000

(b)

	Earnings	No of shares	EPS
1	5 500 000	1 000 000	5,5000
2	5 500 000	1 025 000	5,3659
3	5 500 000	1 050 000	5,2381

(c)

P/E * EPS	Pepper	Salt			Total
		Cash	Shares	Total	
110,00	104 000 000	6 000 000		6 000 000	110 000 000
107,32	104 317 073	3 000 000	2 682 927	5 682 927	110 000 000
104,76	104 761 905		5 238 095	5 238 095	110 000 000

(d)

P/E * EPS	Pepper	Salt			Total
		Cash	Shares	Total	
137,50	131 500 000	6 000 000		6 000 000	137 500 000
134,15	131 146 341	3 000 000	3 353 659	6 353 659	137 500 000
130,95	130 952 381		6 547 619	6 547 619	137 500 000

(e)

P/E * EPS	Pepper	Salt			Total
		Cash	Shares	Total	
82,50	76 500 000	6 000 000		6 000 000	82 500 000
80,49	77 487 805	3 000 000	2 012 195	5 012 195	82 500 000
78,57	78 571 429		3 928 571	3 928 571	82 500 000