

Financial Strategy –May 2003

Question One

Background

Dobbs plc is an international publishing company based in the United Kingdom. It has recently sold a subsidiary that publishes technical journals, a field the company considered to be non-core business. The sale raised £30 million in cash. The directors are evaluating what they consider to be a very promising acquisition opportunity and the cash raised from the sale of the subsidiary would be used as part of the financing arrangement.

Potential investment in a new subsidiary

Alice Jain Inc is an American publisher that has two main divisions. One division publishes books, mainly "blockbuster" type fiction, and the other publishes "lifestyle" magazines. Both divisions have seen strong growth over the past five years as a result of changes in the public's magazine-buying habits and also because of two high-selling authors whom the company contracted before they became popular. These contracts have between three and five years to run before they are re-negotiated. Many industry observers think Alice Jain Inc has been successful because of good luck rather than good judgement and that with stronger management the company could become a major international publisher.

Alice Jain Inc is privately owned (that is, it does not have a listing on a stock market). There are approximately 50 shareholders although 60% of the shares are owned by the husband and wife partnership that started the business 25 years ago. Dobbs plc's directors have already made an informal approach to Alice Jain Inc's directors and believe they will be receptive to an offer if terms can be agreed. No announcement has yet been made to the press or to Dobbs plc's shareholders about their intentions.

On the basis of industry information and private sources, Dobbs plc's directors forecast the following cash flows from Alice Jain Inc:

<i>Year</i>	<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>
Net cash flows (\$ millions)	35.5	43.5	46.5	52.5

NOTES:

(1) The spot \$US / £ exchange rate is 1.45. Forecast economic data relevant to the USA and the UK is as follows:

	USA	UK
Risk-free rates for each year	3.5%	4.5%
Inflation rates for each year	2.5%	3.2

Assume the theory of interest rate parity applies when forecasting exchange rates.

- (2) The cash flows are in real terms. Dobbs plc evaluates all its investment decisions at its domestic, post-tax cost of capital, which is a nominal 11%. It evaluates international investments by converting the foreign currency cash flows to sterling and applying its domestic cost of capital of 11%. The cost of capital for Alice Jain Inc is not known. Dobbs plc's Finance Director has used the capital asset pricing model to assist in the calculation of a discount rate based on the published information about a quoted British company with a similar commercial and financial profile to Alice Jain Inc. He has calculated that the proxy company's nominal, post-tax cost of capital is 13%.
- (3) When evaluating investments, Dobbs plc ignores cash flows beyond four years and terminal values

Financing of the acquisition

Dobbs plc's directors are considering offering Alice Jain Inc's shareholders either shares in Dobbs plc or a cash alternative. The two majority shareholders are likely to take 50% shares, 50% cash as there are tax advantages to a share exchange. This will use up most of the cash from the sale of the subsidiary. The cash for the remaining shareholders will have to be raised by Dobbs plc increasing its borrowing. The "worst case" scenario is that the remaining shareholders (that is, those except the two major shareholders) will all opt for cash.

Finance Director's concerns

Dobbs plc's long-term debt to equity ratio is relatively high compared with other publishing companies of similar size. The Finance Director thinks some of the cash raised from the sale of the subsidiary should be used to purchase a small British publishing company at an approximate cost of £15 million. The remaining cash should then be used to repay some of Dobbs plc's outstanding debt.

The other directors disagree and believe the financial risk of investing in Alice Jain Inc will be justified by substantial value enhancement strategies that can be put in place following the acquisition.

Summary financial information on bidder and target companies

	Dobbs plc £ million	Alice Jain Inc \$ million
Profit and loss account for 12 months To 31 December 2002		
Turnover	251.5	75.8
Operating profit	65.6	20.9
Interest payable	12.0	2.0
Profit before tax	53.6	18.9
Taxation	15.0	7.0
Balance sheet at 31 December 2002		
Fixed assets	195.0	45.0
Net current assets	75.0	25.0
Total assets less current liabilities	270.0	70.0
Long-term debt	125.0	15.0
Net assets	145.0	55.0
Ordinary share capital:		
Ordinary shares of £1	45.0	
Common stock of \$1		15.0
Total reserves	100.0	40.0
Equity shareholders' funds	145.0	55.0

Current share price for Dobbs plc is 885 pence. High and low share prices for the past 12 months were 925 pence and 755 pence respectively.

No share price is available for Alice Jain Inc

Question 1 (continued)

Assume you are a financial manager with Dobbs plc.

Required:

- (a) (i) Calculate the present value of the investment / acquisition's cash flows and explain your method of evaluation, including your choice of discount rate.
- (ii) Calculate the number of shares Dobbs plc might need to issue and the amount of debt that might need to be raised in the "worst case" scenario. Include brief comments to explain your calculations.

(Total for part (a) = 16 marks)

- (b) Write a report to the directors of Dobbs plc, evaluating the potential acquisition. You should include in your report:
- (i) a recommendation, with reasons, of whether the investment should proceed and at what price;
- (ii) advice on strategies for enhancing the value of the combined company following the acquisition;
- (iii) discussion of the Finance Director's recommendation to acquire a smaller company and repay some debt;
- (iv) advice on Dobbs plc's directors' responsibilities to ensure fair and equal treatment for all shareholders in accordance with current takeover regulation.

Use additional calculations to support your arguments wherever relevant and appropriate.

Note: Marks are distributed roughly equally between these four sections of the report.

(Total for part (b) = 34 marks)

(Total = 50 marks)

Question One Answer

Requirement (a)

(i) Calculations

Spot rate

1 year forward	1.450
2 year forward	1.436
1 year forward	1.422
1 year forward	1.409
1 year forward	1.395

Calculation of DCFs/NPV

Year	1	2	3	4
Cash flows in US\$ million	35.5	43.5	46.5	52.5
Inflated at 2.5% each year	36.4	45.7	50.1	58.0
Converted to £million using exchange rates above	25.3	32.1	35.5	41.6
Discount factor at 11%	0.901	0.812	0.731	0.659
DCFs in £	22.8	26.1	26.0	27.4

Present value of discounted cash flows for years 1-4 @ 11% = £102.3 million

Discount factor at 13%	0.885	0.783	0.693	0.613
DCFs in £	22.4	25.1	24.6	25.5

Note: Forward exchange rates can be calculated from the given information using either purchasing power parity or interest rate parity. Either approach is theoretically acceptable, but the question requests candidates to use interest rate parity.

Discussion

The present value (PV) of the cash flows for the four years represents what Dobbs plc might be prepared to pay as an initial investment for the acquisition of Alice Jain. PV analysis is theoretically sound and a sensible approach in the absence of a quoted share price to use as a benchmark. Asset values could have been used, but these would ignore the value of intellectual capital (the authors' earnings) in Alice Jain Inc.

There are two basic approaches to evaluating international investments using present value analysis. One approach is to discount the local cash flows at the local cost of capital and then translate the present value analysis into the home currency. The other translates the local cash flows into the home currency using appropriate exchange rates and then discounts at the home cost of capital to give a present value (or a NPV, if an initial investment is part of the calculations) in the home currency. In theory, the answers should be identical but, in practice, minor inefficiencies and imperfections in the market will allow for differences ..

Many of the considerations to arrive at a discount rate for international investments are the same as for domestic projects, but there are additional risks to consider such as political, economic and transaction risks. The discount rate needs to be adjusted for the increased risk and international cash flows, but it may also be argued that international diversification reduces risks. Risk will also be affected by the correlation of the project's cash flows with those of domestic projects, and by the inter-temporal correlation of cash flows.

The choice of 11 % as a discount rate applied to home currency is therefore acceptable, but in the circumstances here may not fully incorporate the risk of the investment Alice Jain Inc's cost of capital is estimated as 13% However, Nce Jain Inc has a lower gearing ratio (21 A% debt to total assets less current liabilities compared with 46.3% for Dobbs pic) Assuming the Finance Director has adjusted for this in his calculation of 13% using the CAPM, the business risk inherent in Alice Jain Inc appears to be higher than Dobbs plc and the use of a higher discount rate might be advisable The calculations also show the present value that would be expected if Dobbs plc applied a 13%, discount rate.

(ii) Calculations of number of shares/debt required

Assuming 13% is an appropriate specific risk adjusted discount rate in the circumstances, then Dobbs pic will be prepared to pay a maximum of £97.6 million for the acquisition of Alice Jain Inc. It is difficult to value shares in a private company and there is likely to be some difference between our valuation and that of Alice Jain Inc's shareholders Given the maximum price that we would wish to pay, an initial bid of perhaps £84.5 million could be considered (using the PIE ratio valuation), emphasising the potential for future value that Alice Jain Inc's shareholders would receive from a share exchange in preference to a cash offer.

However, working on the maximum price Dobbs plc should consider paying would give the following bid terms:

There are 15 million shares (common stock) in issue. The two major shareholders own 60%, or 9 million shares. If they take cash for 50% and the remaining shareholders all take cash, this is 10.5 million shares for cash and 4.5 million share exchange

If we assume a present value of £97.6 million is the maximum price Alice Jain Inc is worth to Dobbs plc, and 70% $\frac{10.5}{15} \times 100$ opt for cash and 30% for a share exchange, this will require:

£68.3 million cash (£97.6 million x 70%) or its equivalent in US\$ at the time of purchase
 The issue of 3.31 million shares $\frac{£29.3 \text{ million}}{\text{Dobbs' share price of 885p}}$

The share issue will require the approval of Dobbs plc's shareholders The sale of the subsidiary raised £30 million. Assuming no other events have required use of this money,

Dobbs plc would need to raise a further £38.3 million in long-term debt to finance the cash part of the bid.

Requirement (b)

Report

To: The Directors of Dobbs plc

From: A Financial Manager

Date: 20 May 2003

Evaluation of acquisition of Alice Jain Inc

Introduction

I have reviewed the relevant information relating to the proposed acquisition of the US-based publishing company, Alice Jain Inc. The terms of reference for this report are as follows:

- (i) To recommend whether the investment should proceed and at what price;
- (ii) To advise on strategies for enhancing the value of the combined company following the acquisition;
- (iii) To evaluate the Finance Director's recommendation to acquire a smaller company and repay some debt;
- (iv) To advise on the company's responsibilities to shareholders under the takeover code.

These terms of reference form the basis of the four main sections of the report

Recommendation of whether the investment should proceed

The value of the company and per share using three methods of valuation are shown below:

	P/E ratio method	Present value at 13%	Asset value
Value of company £ million			
EPS 79.3 cents (54.7 pence at spot)			
x by Dobbs PIE of 10.3			
x shares in issue	84.5		
Per answer to requirement (a) (i)		976	
Per accounts (\$55 million/spot)			37.9
Price per share	563p	651p	253p

Based on the calculations for requirement (a) (I), the maximum price Dobbs plc should consider paying is £97.6 million, given the assumptions about the discount rate. However, the value based on Dobos plc's PIE provides a good benchmark, although Alice Jain Inc would probably command a higher PIE if it were to be floated as a listed company. This is because, if the Finance Director's cost of capital calculation is correct, then the company may expect higher growth and, therefore a higher PIE. Also new and smaller companies tend to attract higher P/Es on flotation. The value of the company may be further enhanced if an estimate of cash flows beyond year 4 and terminal values were to be attempted. A time horizon of four years is very short for an investment such as this.

The asset value is of limited usefulness in a company such as this, which earns its Income largely from intellectual capital that generally does not feature in the balance sheet

There is clearly potential for value enhancement if only because the risk-diversifying aspects may well lower the cost of capital and therefore increase the value of the firm An Issue that needs to be considered is the effect on gearing and financial risk if ,he company has to borrow to finance this acquisition. This is discussed further in section (iii) of this report

(ii) Advice on strategies for enhancing the value of the combined company following the acquisition

The following are. key points we should consider when determining our strategy:

The integration strategy must be In place before the acquisitionis finalised

We should review each of the company's business units for potential cost curtings/synergies or potential asset disposals It is possible there are units more valuable to another company than Dobbs plc, but it is important they are in good shape before they are sold. A straightforward ratio analysis could be considered to evaluate and compare the various component parts of A\ice Jain Inc's business. However, more than this is needed for a full effective enhancement programme and a position audit could be carried out

We should consider the effect on the workforce and determine how many, If any redundancies are likely and what the cost will be .

We should review the authors' contracts to ensure they do not lopse when the acquisition is completed .

There is a need to pursue a more aggressive marketing strategy for the magazine division, in particular can some of the US magazines be markeled in the UK, and vice versa?

The company's cost of capital should be re-evaluated. the level of diversification obtained by merging two different income streams might reduce this and therefore increase the value of the company .

We should make a positive effort to improve communication within the organisation to prevent demotivation and avoid "NIH" (Not Invented Here) syndrome and other well-known, adverse post-acquisition effects on staff morale

This is, basically, a horizontal merger and there may be economies of scale that we should aim to identify and evaluate

We should do a review of assets and consider selling non-core elements or redundant assets.

Note: Valid comments about marketing strategy would be acceptable, although this is not the focus of the question.

(iii) Evaluation of the Finance Director's recommendation to acquire a smaller company and repay some debt

The decision to invest or divest hinges on the opportunity cost of capital. If we assume

the return required by shareholders does take into account the financial risk of the company, and

the interest rate of the debt in the company's capital structure is less than 11 % after-tax, and

the company can find positive NPV Investments at 11 % or above,

then, in theory, the company should continue to use debt financing. Repaying the debt would not be in the best interests of shareholders unless the debt is at a variable rate and the company expects rates to increase in the near future.

Without comparable industry figures it is difficult to comment on whether the gearing ratio is excessively high (we are only told it is "relatively" higher than other publishing companies of similar size) However, the ratio does not appear to be excessive at around 46% on book values at the last balance sheet date and interest cover is adequate Also, the balance sheet as at 31 December 2002 does not reflect the £30 million cash raised from the recent sale of a subsidiary. Assuming this amount is still a cash resource then one valid basis for calculating gearing would be to deduct this amount from long term debt More recent information is necessary before an accurate calculation can be made, but it is reasonable to assume the gearing percentage would decrease.

In theory, market values should be used to calculate gearing The Current market value of Dobbs plc's equity is £398 million (45 million shares at 885 pence each) If we assume debt is valued at par then the gearing ratio (debt / (debt + equity)) is only around 24%.

However, it is not clear how the Finance Director has identified the small British publisher to acquire or what other opportunities might exist for the use of the money This potential investment would need to be evaluated in the same way as Alice Jain Inc. Purchasing a British publisher may reduce transaction, economic and possibly political risk, but there is no indication that it will provide any better strategic fit than Alice Jain Inc The expected return to this company would need to be assessed.

(iv) Advice on the implications of the company's responsibilities to ensure fair and equal treatment for all shareholders in accordance with current take over regulation

The UK Code does not have the force of law, but its main function is to ensure directors carry out their duties "without prejudice in a fiduciary manner". That is, they must show trustworthy behaviour for the benefit of shareholders equally

The Code may not have the force of law, but the panel does have some powerful sanctions. These may take the form of public reprimands or the shunning of Code-defiers by the regulated City institutions. No regulated firm (such as a bank, a broker or an adviser) should act for client firms that seriously break the panel's rules.

The fundamental objectives of the Takeover Panel regulation are to ensure fair and equal treatment for all shareholders. The main areas of concern for the directors of Dobbs plc in the takeover of Alice Jain Inc are:

Shareholders being treated differently - for example, the two large shareholders should not be seen to be getting a special deal;

Insider dealing (control over this is assisted by statutory rules);

Management action which is contrary to its shareholders' best interest _ for example, the advice to accept or reject a bid must be in the shareholders' best interest, not that of the management;

Lack of adequate 2nd timely information released to shareholders

Artificial manipulation of share prices - for example, an acquirer offering shares cannot make the offer more attractive by getting friends to push up its share price;

The bid process dragging on and thus distracting management from its proper tasks.

It would also be necessary for Dobbs plc to recognise competition regulation in the US.

Summary

This report has aimed to provide an evaluation of the proposed acquisition of the US company, Alice Jain Inc. In summary, it recommends that the acquisition should proceed although a review of alternative possibilities for acquisition should be considered. The recommended price is a maximum of £97.6 million, financed by a combination of the issue of new shares, retained cash and new debt. An initial bid of around £845 million could be suggested. This figure is based on the benchmark of Alice Jain Inc's earnings multiplied by Dobbs plc's PIE ratio.