

Financial Strategy –November 2001

Question One

BACKGROUND

Margate Group plc is a large, long-established company whose primary interests are in transport and distribution within the United Kingdom. It is considering a bid to acquire Hastings plc, a company also in the transport and distribution industry. Hastings plc, however, has a strong operations base in Europe as well as in the UK. Both companies are listed on a recognised stock exchange. They both have a wide share ownership including many institutional investors.

Hastings plc has recently fought off a bid from a company based in the United States of America and has made a public statement that it will defend itself against any future bids. The company has recently won a fiercely contested five-year contract to undertake transport and distribution services for a major supermarket group. Margate Group plc also tendered for this contract. Press comment suggests this contract will allow Hastings plc's earnings to grow at 10% a year for at least the next five years. However, some industry experts believe Hastings plc tendered a price that was so low that the contract could result in very little profit, or even losses.

If the acquisition were to succeed, it would create the largest company of its kind in the UK. A concern is that this would attract the interest of the competition authorities. However, as both companies have recently restructured their operations, redundancies are likely to be few and

FINANCIAL STATEMENTS

Key financial information for the two companies for the latest financial year is given below. All figures are in £ million unless otherwise stated.

Profit and loss accounts for the year to 31 August 2001

	Margate Group plc £ million	Hasting plc £ million
Turnover	2,763	1,850
Operating costs	<u>1,950</u>	<u>1,380</u>
Operating profit	813	470
Net interest	<u>125</u>	<u>85</u>
Profit before tax	688	385
Tax	<u>185</u>	<u>85</u>
Earnings	503	300
Dividends declared	<u>201</u>	<u>135</u>
Retained profit for the year	<u>302</u>	<u>165</u>
Earnings per share (pence)	47.90	35.29
EPS for year to 31 August 2000 (pence)	34.85	29.50

Balance sheets at 31 August 2001

	Margate Group plc £ million	Haseting plc £ million
Fixed assets (Net Book value)	3,250	2,580
Current assets		
Stock	125	175
Debtors	550	425
Cash at bank	450	45
<i>Creditors: due within 1 year</i>		
Bank loans and overdraft	0	420
Other	755	365
<i>Creditors: due after 1 year</i>		
Debenture (see note below)	1,450	950
Taxation Net assets	<u>150</u>	<u>40</u>
	<u>2,020</u>	<u>1,450</u>
 <i>Capital and reserves</i>		
Issued share capital (ordinary £1 shares)	1,050	850
Revaluation reserve	220	150
Profit and loss account	<u>750</u>	<u>450</u>
Total shareholders' funds	<u>2,020</u>	<u>1,450</u>

Note: Margate Group plc's debenture is 8%, repayable 2005. Hastings plc's is 19%, repayable 2004.

Share price information (price in pence)

	Margate Group plc	Haseting plc
Share price movements:		
High for last financial year	705	590
Low for last financial year	470	440
Share price today (20 Nov 2001)	671	565
P/E ratio today	14	16
Equity beats	1.1	1.2

OTHER INFORMATION

- The average P/E for the industry is currently estimated as 13.
- The return on the market is currently estimated as 12%, the risk-free rate as 6%. These rates are expected to remain constant for the next 12 months and are post-tax.
- The average debt ratio for the industry (long-term debt as proportion of total long-term funding) is 30% based on book values.
- Economic forecasts provided by Margate Group plc's financial advisors expect inflation and interest rates to remain at their current levels for the foreseeable future. Inflation is currently 2% a year.

Terms of the proposed bid

Margate Group plc's directors are planning to offer a share exchange to Hastings plc's shareholders.

Required:

- (a) Calculate and discuss briefly three key ratios for both companies that are relevant to the evaluation of the proposed acquisition.

(9 marks)

- (b) Calculate a range of possible values that Margate Group plc could place on Hastings plc, using both P/E basis and the dividend growth model.

Accompany your calculations by brief comments or explanations. Where necessary, explain any assumptions you have made.

(9 marks)

- (c) Assume you are the Financial Manager with Margate Group plc. Write a report to the Directors of the Group that evaluates the proposed acquisition.

You should use the figures you have calculated in answer to parts (a) and (b) to support your recommendations / advice where relevant. If you have not been able to do the calculations for parts (a) and (b), you should make, and state, appropriate assumptions.

Your report should include the following topics.

- (i) Recommendation to the Directors of a bid price and offer terms, assuming a share-for-share exchange.
- (ii) Advice on a strategy for making the offer to Hastings plc to minimise the likelihood of outright rejection by the Hastings plc board, and a discussion of the other risks involved in making the bid.
- (iii) Discussion of the strategic and financial advantages that might arise from the acquisition by Margate Group plc of Hastings plc.

Support your discussion with calculations of the post-acquisition value of the combined group and how the estimated gains are likely to be split between the shareholders of Margate Group plc and Hastings plc.

(32 marks)

(Total = 50 marks)

Question One Answer

Requirement (a)

Evaluation of the financial performance of Hastings plc

Three key' ratios have been selected for the preliminary evaluation of this company. These are:

Operating profit percentage;
return on net assets;
gearing; and
the current ratio.

	Margate Group plc	Hastings plc
Operating profit percentage	29.4%	25.4%
	813	470
	2,763	1,850

This ratio shows operating profit (turnover less operating costs) as a percentage of turnover. Hastings pic's performance was worse than ours was for the past financial year. However, the company's managers would probably expect this ratio to improve following The ward of the new contract.

	Margate Group plc	Hastings plc
Return on net assets	23'4%	19.6%
	813	470
	(2,020 + 1,450)	(1,450 + 950)

This ratio indicates the productivity of long term assets. Again, Hastings plc seems inferior to Margate Group plc. Details of the new contract are not available, but it is likely this ratio will also improve next year. More detailed information on asset valuations and depreciation policies will be needed before an accurate comparison can be made.

	Margate Group plc	Hastings plc
Gearing (book values)	41.8%	39.6%
	1,450	950
	(1,450 + 2,020)	(950 + 1,450)

Hastings plc 39.6% 950 Gearing ratios are similar for both companies and both are somewhat higher than the industry average. If the terms of the acquisition are share exchange, this will affect this ratio significantly. This is commented upon further in the next section of this report.

	Margate Group plc	Hastings plc
Current ratio	1.5 : 1	0.8:1
	1,125: 755	645:785

Hastings plc is either managing its liquidity very efficiently or is dangerously illiquid, depending on viewpoint. The company has a very high cash balance at present, which suggests an inefficient use of this resource. If the cash received as part of the acquisition terms is used, then, all other things remaining equal, the current ratio would fall to just over 1.

Requirement (b)

Estimate of value of Hastings plc

Discounting expected future cash flows arrives at the theoretically correct value for the company. However, as this is likely to be a contested bid we are unlikely to get any accurate information about Hastings plc's future cash flows and must therefore base our valuation on publicly available information. We can use two methods: PIE ratio or the dividend valuation model.

P/E ratio method

Hastings plc's current PIE ratio is 16 and the market capitalisation of the company is £4.8 billion (Earnings of £300 million (m) x PIE of 16). However, the market value of the company during the last financial year has shown dramatic movement. Using last year's high and low share prices and EPS, we get the following range of market values and PIE ratios

Market capitalisation	PIE ratio
Low (850 million shares' 440p) = £3.740 billion	12.5
High (850 million shares • 590p) = £5.015 billion	16.7

The industry average PIE is 13, but more information would need to be known about the make up of this average before it could be used as any sort of a guide.

Dividend growth model

The basic formula is $P_0 = \frac{d_1}{k_e - g}$

Assumptions for the purpose of evaluation

The 10% growth forecast for the next 5 years is maintained indefinitely. This might be unrealistic, but is the best estimate we can get at present and will at least give us a "ball park" figure on which to base further discussions.

Ke using the CAPM is $6\% + 1.2(12\% - 6\%) = 13.2\%$.

This assumes the beta is unaffected by the new contract which mayor may not affect the business risk of the company.

Value of Hastings plc is therefore: $\frac{£148.5m}{0.132 - 0.10} = £4.64 \text{ billion}$

The value on this basis is approximately 3% less than the current market value, which suggests the market has some confidence in the forecasts of sustained growth for the company.

Requirement (c)

Report

To: Directors of Margate Group plc
From: Financial Manager
Subject: Evaluation of the proposed acquisition of Hastings plc
Date: 20 November 2001

Introduction

This report addresses our proposed acquisition of Hastings plc. It is in three sections. The first section recommends a bid price and offer terms. The second section advises on a bid strategy and on the risk involved in making the bid. The third and final section discusses the strategic and financial advantages that should arise from the acquisition.

Section (i) - Recommendation of bid price to the directors

Using two methods of valuation we have a range of values. The market value of Hastings plc moved between a low last year of £3.74 billion to a high of just over £5 billion. The current market value is £4.8 billion, which is close to the value obtained using the dividend growth model. The current PIE ratio of Hastings plc is considerably higher than the industry average and also higher than ours, suggesting the market is more optimistic of Hastings plc's growth potential. If the market is at all efficient, then the market value should be a fair estimate of the true worth of the company. However, the PIE could well be reflecting the market's expectation of a new bid for Hastings plc and therefore "overvalues" the company. Overvalued or not, we could not offer the shareholders anything less than the current market value and hope to Succeed. It, therefore, has to identify financial and strategic benefits that would accrue from the merger to justify paying the necessary price. These benefits are discussed further in section (iii) of this report.

Evidence on share price movements of previous contested bids shows that, typically, bidders have to pay in excess of 30% above the market value to obtain control. If this were the case here, we would need to pay £6.24 billion to obtain a company that our rough estimates suggest is worth only £4.64 billion using the dividend growth model. This means we need to identify savings and synergies of over one and a half billion pounds to make the merger financially worthwhile.

The comments being made by some industry experts are also worrying. If Hastings plc has under-cut the market to gain the new supermarket contract, we could be buying a huge liability. If our bid is contested, we will not know this until we have succeeded, when it will be too late.

For the purposes of this report I recommend that we make an initial offer of the current market value plus 10%, that is £5.28 billion, or 621 pence a share. Our share price is currently 671 pence a share. This would imply a share exchange of approximately ten Margate Group plc shares for eleven Hastings plc shares. However, once the bid is announced the market will reevaluate both companies and a revised bid will be almost inevitable. The issue of new shares will of course have to be approved by the shareholders.

Section (ii) - offer strategy and risks involved in making the bid

I recommend that the board seriously consider an informal approach to Hastings plc with a view to an agreed bid. This would allow us access to more information before we agree a price. The disadvantage is of course that, should Hastings plc reject our approach outright, we have placed our interest in the public domain. Hastings plc would have time to put together a reasoned defence and the market would immediately mark up their share price (and ours possibly down). The inevitable result of this is that we would end up paying even more to acquire the company than if we launch a hostile bid without any preliminaries. Another risk factor is the possible attention of the competition authorities. If our bid is referred this will have two effects:

It will cost us substantial amounts of time and money preparing and providing the information and documentation required by the Authority; and

It will give Hastings plc time to put together a more comprehensive defence, possibly allowing it to form other strategic alliances that would be to our long-term disadvantage.

The bid may be referred whether or not it is agreed, but if we are able to hold amicable and early discussions we may be able to take informal soundings from the authorities as to how they might react to the acquisition announcement.

Section (iii) - Strategic and financial advantages of the merger

The strategic advantages are fairly obvious: we would create the largest transport and distribution group in the UK, which would give us a significant expansion of routes and resources and should allow some economies of scale in central administration. We would also acquire some expertise in contract negotiations. The new contract won by Hastings plc would also give us an opportunity to expand this type of business in an area where we have significantly failed to succeed before. The results of this should be an improvement in profitability and returns on assets.

The acquisition would create an organisation with a market value of approximately £ 12 billion if we simply add together today's market value of the two companies. It would be worth undertaking an exercise to look at the post merger values and ownership of the two companies assuming a range of possible bid terms to determine how the benefits of the acquisition would be shared between the two companies' shareholders. An example is shown below, assuming we eventually end up offering a one for one share exchange, which is close to a 20% premium on Hastings' current share price (671 pence for 565 pence):

	Margate Group plc	Hastings plc	Combined
Historic earnings (£m)	503 (63%)	300 (37%)	803 (100%)
Shares in issue (millions)	1,050	850	
Share price pre-merger (pence)	671	565	
Shares in issue post-merger (millions)	1,050	850	1,900
Percentage ownership	55%	45%	100%
Value of shares post-bid (£billion) assuming a PIE of 16 is applied to the combined group	7.066	5.782	12.844
Share value pre-merger (pence) based on post-merger values	673	680	

You will see that I have applied Hastings plc's PIE ratio of 16 to the earnings of the combined group. It could logically be argued that this is too optimistic and a weighted average PIE would be more appropriate. However, if we proceed on the proposed terms and use a PIE of anything less than 16, we should expect a substantial fall in our share price. For example, if we use a PIE of 15, the value of the combined company would be £12'045 billion which would imply a current share price for us, based on post merger values, of 631 pence [(£12,045 billion x 55%)/1.050 million shares].

As we can see, Hastings plc's shareholders take almost all the gains from the acquisition, which are substantial. However, a much more detailed sensitivity analysis should be carried out using different assumptions for each of the variables. For example, other financial advantages that might arise following the acquisition and which might affect the company valuations, and hence bid terms, are:

Reduction in gearing that might lower the cost of equity. It is unlikely there will be much of a reduction in business risk as our two companies are in the same industry and there are unlikely to be diversification benefits.

Increased debt capacity. Our gearing ratio and Hastings plc's are similar and high for the industry. If we offer a share for share exchange, and assuming our shareholders approve an increase in share capital, the ratio will fall when we merge. This might allow us to increase our borrowings, but this will depend on many other factors, economic and business.

Improved utilisation of resources that should benefit profitability and cash flows. We have just completed a restructuring that has provided us with improved resource utilisation. We will not know the real situation in Hastings plc until we have access to its records.

Hastings plc's current ratio is low, as noted in section (i) of this report. Ours is probably too high. There is, no doubt, scope for improvement in working capital management.

Summary and conclusion

This report has aimed to provide a preliminary review of the advantages and disadvantages of pursuing what is likely to be a hostile take-over of Hastings plc. I have identified some serious concerns, not least the apparent illiquidity of Hastings plc, its current high market value and the difficulty of identifying any concrete synergies. Added to these considerations, we must recognise the fears of industry insiders about some of Hastings plc's business practices and the possibility of a referral to the competition authorities. We must also obtain the permission of the shareholders to increase the share capital if we are to make a paper bid. On the information so far, we would struggle to persuade the shareholders that the take-over is in their interests.

Signed: Financial Manager.

