Question 1

The motives for LBO of Southland can be analyzed through operational and financial perspective. Operationally speaking, the revenue growth slowed down from 1981 to 1986, and the integration could be an important source to break the ice. Integrating gasoline marketing with convenience stores can “integrate” the customer base of both services as well thus generating more revenue. A greater and more loyal customer base can be utilized for further expansions, like Citgo Plus credit card as an example.

Financially speaking, it is safe to promote an LBO plan. The debt-to-equity ratio has been decreasing dramatically during 1981 to 1986 from 90% to 40%, which implies a good opportunity to “lever up”; stably increasing cash flows also showed Southland is financially healthy. Generally speaking, Southland can utilize its financial health with an LBO plan to improve its operational performance.

Question 2: Value of Southland’s shares under LBO plan

Assumptions we made through LBO plan:

1. Tax rate = 36%, ERP = 8%
2. Risk-free rate = 8.6% (10-year U.S. treasury rate during July 1987)
3. Unlevered asset beta = equity beta \* E/(D+E) = 0.78
4. Tax shield discount rate = 10% (bond discount rate)
5. Terminal Value is calculated by assuming no change of FCF & Tax shield after 1997
6. Total debt = $1146199 (Exhibit 8)
7. Common Shares Outstanding = 52.9 (Page 5)

Under these assumptions, we calculate a share price of $82.79