

Valuation of R Tools Ltd.

Executive VP of X Inc. was reviewing an acquisition candidate for his company's diversification program. One of the target companies they wanted to approach was R Tools Ltd.

X Inc. was a leading producer of engines and massive compressors used to force natural gas through pipelines and out of wells. Management was concerned over its heavy dependence on sales to the oil and gas industry and violent fluctuations of earnings.

X Inc. wanted to develop an acquisition strategy to diversify its business. They wanted to acquire only leading companies in their respective market segments.

R Tools Ltd. was one of the largest domestic manufacturers of cutting & edge hand tools with a leader in two of its' product lines. R tools Ltd. offered a broad, high-quality line with a very strong brand name.

However, the company was not performing well as compared to similar companies in the same industry.

The industry growth rate of cutting & edge hand tools' industry was 6% per year.

The P-E ratio for R Tools Ltd. was 10-12 showing a lack of investors' interest in the stock. Price to earnings ratio of this industry was 12-15 times. The profit margins of the industry were 3 times that of R Tools Ltd.

X Inc.'s management was attracted by the potential profits that can be realized from R Tools Ltd. The manufacturing efficiency could be improved by reducing the number of products and reducing the number of inventories. COGS could be reduced by 3% of Sales Revenue over the five years planning period.

There was a substantial overlap of the sales force due to a recent acquisition of a hand tools business line. The selling, general, and administrative expenses (i.e., the operating expenses) will reduce by 2% of Sales Revenue over the five years. After the acquisition, the company might expect a reduction of Net Working capital requirement as a % of sales revenue by 9%.

The Net Property Plant and Equipment will remain the same (as previous) as a % of sales revenue

The growth rate in the free cash flow can be expected to be 5% *p.a.* till perpetuity after the planning period of 5 years.

X Inc. wants to determine the maximum offer price per share. R Tools Ltd. was currently trading in the market at 30\$ per share. The number of shares outstanding is 5,84,000 shares.

The required return or cost of capital of cutting & edge tools industry is 10%. There is no *slack* cash in book.

The last five years Income statement for R Tools Ltd. and the current year ending balance sheet is available with you.