vcubusiness

FIRE 623 Fall 2023-2024
Final Exam

Virginia Commonwealth University

Evaluating Strategic Alternatives

To: MBA Investment Bankers

From: James Lanbros, Chairman of the Board of Directors, CrossFire

Subject: Investment Opportunities

Dear MBA Investment Bankers,

I am reaching out as a follow-up to our conversation last Wednesday, November 29, 2023, regarding our need for financial advice. We are assessing who we will retain as our investment bankers and would appreciate your immediate thoughts on the situation our business is facing.

<u>Situation Overview</u>

Our firm ("CrossFire", "CF", or "the Company"), is a medium sized, non-dividend-paying publicly traded entity operated through two primary subsidiaries, one involved in augmented reality healthcare technology ("CrossHealth" or "CH") and the other involved in virtual reality electronic gaming ("CrossPlay" "CP").

We've recently begun to receive pressure from several institutional investors who hold significant stakes in the Company. One hedge fund, TroubleMaker Capital, publicly released a letter asking the Board of CrossFire to divest CrossPlay and focus on CrossHealth. TroubleMaker argues that this course of action will unlock value long overdue for shareholders, noting that if the Board does not act, they will push to replace the Board and/or to demand a sale of CrossFire.

In the midst of all this, we have actually been thinking of acquiring a certain virtual reality defense training company ("FirstFighter" or "FF") which we believe is highly complementary to our CrossPlay segment. We believe this could be a prime opportunity to accelerate our growth, improve margins, and regain public confidence in our commitment to drive value creation.

Ultimately, we are looking for you to help us through this process and advise us on whether we should increase or decrease our position in electronic gaming by either:

A) Selling CrossPlay in order to focus on CrossHealth, or
B) Acquiring FirstFighter to further bolster CrossPlay's capabilities.

Below you will find additional details for further context on the situation.

CrossFire (CF)

CrossFire, located in Los Angeles, California, offers augmented and virtual reality solutions to the healthcare and electronic gaming industries through its CrossHealth and CrossPlay reporting units, respectively. The Company was founded approximately 40 years ago by Timothy Piersol. Tim resigned as the Chairman of the Board and CEO of CrossFire 15 years ago but is still an important stockholder in the Company and regularly provides advice as a board member. The Company was known as CrossHealth until the formation of CrossPlay several years ago, at which time the Company changed its name to CrossFire.

- Aside from CrossHealth and CrossPlay, there are no other entities that are a part of CrossFire.
- There are no synergies / shared overhead between the two entities.

CrossHealth (CH)

CrossHealth has developed various augmented reality solutions for healthcare applications, such as heads up displays (HUDs) and holographic projections for physicians. Tim originally began this company after developing a mapping application to help his doctor 'show him' what was wrong following a knee injury. Since then, CH has expanded into various other applications for physicians, with over 90% of CH revenues coming from sales to general practitioners. However, Management recognizes that the biggest growth opportunity exists in targeting more complicated, niche surgeries where a doctor's access to live information is most critical. If CH made breaking into this market a strategic priority, Management believes they could see revenues grow an incremental 5% annually without any additional overhead beyond the 1% annual SG&A growth Management is already projecting. However, they do not believe they can successfully implement such a change so long as CrossPlay continues to demand Management's focus and attention.

CrossPlay (CP)

CrossPlay designs, develops, and distributes virtual reality video games for consumer entertainment. CP was founded 10 years ago as a means of capitalizing on the swelling interest in video games that provided a more immersive experience. This segment experienced a spurt of significant growth following the launch of its first major hit, Delta Force, a virtual reality first person shooter simulating special forces activities. Since then, revenue growth has slowed to a more sustainable long-term rate. Management expects the business to benefit from operating leverage as revenue growth outpaces project overhead growth of only 4% annually. However, management recognizes that CP's gross margins are lower than similar peer platforms due to poor distribution capabilities; management notes that if they could access a more sophisticated distribution platform, they would immediately integrate with those systems and drive all of CP's sales volume at that lower price point.

FirstFighter (FF)

FirstFighter has developed a leading virtual reality defense training solution for private security and defense applications. FF utilizes fully immersive simulated scenarios to train armed personnel in realistic, live-fire environments. FF was founded eight years ago by several ex-Marines, though the original founders have all left the business. FF is now privately held by a small group of passive investors that are no longer enamored with the defense industry. In recent conversations, FF's CEO has acknowledged that FF has been able to offer competitive prices due to the attractive gross margin profile of their distribution platform which allows them to cost-effectively produce and distribute these virtual reality solutions to commercial and military customers. However, the CEO has cautioned us that FF is already being approached by a private equity firm, Mean & Lean Partners, though they haven't received a formal offer yet with any potential pricing. Historically, Mean & Lean has been known to only pay for acquisitions where they can drive an internal rate of return ("IRR") of 24% to 26%.

We reached out to Friendly Neighbor Bankers to get a sense of what sort of terms Mean & Lean may be considering if they tried to buyout FF. The key information is included in the transaction assumptions below.

Transaction Assumptions:

- For simplicity, please assume if a transaction occurs, it will close at the end of the year (December 31, 2023) and a future exit would occur in five years (December 31, 2028).
- Companies with similar size and cash flow generation are seeing leverage levels as high as 4.0x of total debt to EBITDA. Based on initial discussions, lenders have expressed a willingness to provide senior term debt of up to 3.0x to EBITDA plus subordinated debt of up to 1.0x EBITDA.
- Lenders are quoting pricing of 10% cash interest on senior debt and 12% cash interest on subordinated debt.
- Lenders are expecting at least 1.3x total fixed charge coverage ratio.
- Expect future exit multiples to be equal to the acquisition multiples. (i.e. the multiples in five years will be the same as they are today).
- Assume annual interest payments based on the average debt balance throughout the year.
- Neither CF nor FF has any short or long term debt or tax implications.

Other Factors

- Though Tim is no longer Chairman of the Board or CEO of CF, his son and daughter are still involved with CF; his son, Joseph, leads the CH segment while his daughter, Nikki, currently leads CP.
- The current CEO of CF, Bob Wilson, has provided an estimate for financial performance by the end of 2023 as well as the current P&L budget for 2024. He encourages conservative assumptions in projecting future business performance: i) no future gross margin expansion, ii) consistent capital investment in the business as a % of revenue, iii) continued growth in overhead, and iv) balance sheet ratios (Days Receivable/Payable, Inventory Turns, etc.) to remain in line with 2023 estimates.
- Recent experience suggests that these business are valued based on EBITDA and often see their cash flows discounted at 14.5% to 15.5%.
- Moreover, Bob Wilson recognizes that while transformational changes to the business (such focusing on CH growth or integrating CP with FF) may drive higher purchase multiples today, he would not expect future terminal multiples to rise above current transaction multiples.
- In the event of an acquisition for FF, CF has access to inexpensive debt today and management believes they can raise additional non-amortizing debt up to 3x total pro forma EBITDA at 10% cash interest.

- Approximately 7.2 million fully diluted shares are held by the Piersol family (Tim and his son and daughter), with the rest held by the public. Institutional investors, including Trouble Maker Capital, own a combined 8.0 million shares. There are 20.0 million shares outstanding in total.

Next Steps

We have included financial and other data for CrossHealth, CrossPlay, and FirstFighter to assist you in your evaluation. Please see the attachment to this letter. Using the data provided, please provide us with the following:

1. An overview of valuations
    a. What are the fundamental valuations of CrossFire's businesses (CrossHealth and CrossPlay) utilizing the following approaches:
        i. Comparable companies
        ii. Comparable precedent (i.e. historical) transactions
        iii. Discounted cash flow (DCF) analysis
    b. Using a simple leveraged buyout model ("LBO") similar to the one you prepared for your client in the DuPont Protective Coatings deal, how much do you believe Mean & Lean would be willing to pay to acquire FirstFighter? Assume a very simple debt structure where banks will lend 3.0x pro forma (i.e. forecasted) EBITDA at 10% cash interest on a non-amortizing basis.
2. An overview of the impact/value creation for total CrossFire shareholder equity value if:
    a. Alternative 1: We spun off CrossPlay and focused on CrossHealth.
    b. Alternative 2: We acquired First Fighter and integrated this platform with CrossPlay.
3. A qualitative outline of the trade-offs between alternatives available to the Company.
4. Your recommendation of the strategy the Board of CrossFire should pursue.

If you have additional questions regarding content that cannot be answered with the materials provided in this package, you should ***not*** conduct additional outside research. Instead, you should:

- Make assumptions about any missing information; and
- Indicate in your presentations the assumptions you have made.

You can submit your presentation in any format you would like (PowerPoint or Word). Please insert tables from any Excel work into your presentation but provide the original Excel with your submission. The appearance and organization of your submission will weigh heavily on who we ultimately select to represent us in this matter. ***Hint: "football field" graphs are very nice ways to present valuation summaries.***

Please make your presentation as succinct, yet thorough, as possible. Well-selected graphics, bullet points, etc. are completely acceptable.

Thank you very much. We look forward to reviewing your work. Please make sure you have it submitted to us by December 13, 2023 at 9:40 pm.