FINC3600 Project 1 WOW
– CC Workshop 4 - Team 2

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Key Recommendations

- We suggest Woolworths to enter the pharmaceutical industry to capture more growth opportunities by acquiring 100% of the shares in Sigma Healthcare (SIG.AX) via a scheme of arrangement.

SIG	SIG.AX	IDX.AX
Market Cap ($m)	677.94	745.85
Price to Book Value	1.39	2.79
EV to EBITDA	42.55	32.52
EV to Sales	0.27	2.88

- The integration will also make further capital expenditure in data and technology an attractive growth opportunity to boost the performance of both of their rapidly growing online business.

WOW has a strong synergy with SIG, the acquisition is expected to benefit both firms significantly as they adjust and evolve in response to Covid-19.

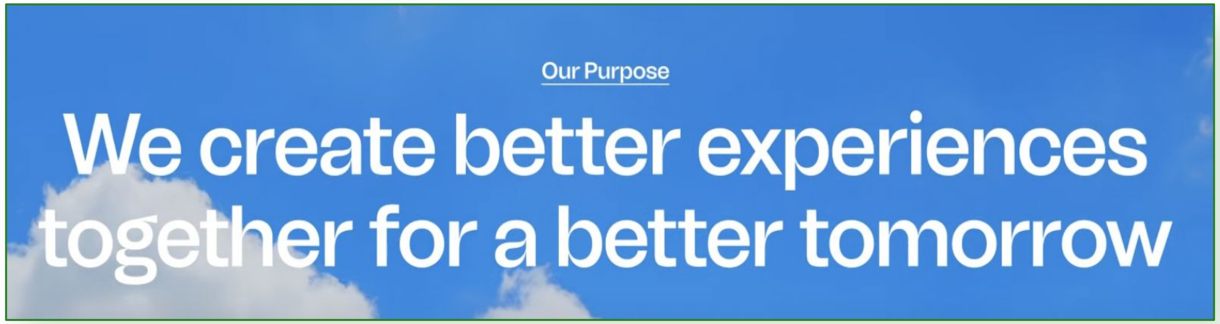
- WOW has evolved a mature food and everyday needs ecosystem. Incorporating SIG extends its ecosystem into provision of health and wellness services. It can help boost customer loyalty further.

- WOW's service capabilities in eCommerce, retail media, data and analytic, and logistic network can help further strengthen SIG's existing business model.

- 10 years experience in logistics industry can effectively alleviate delivering pressure of WOW's due to the increasing demand eCommerce purchase.

- The distribution centres owned by SIG are located in the main cities that have the highest density of Woolworths stores, which enable the group to provide a more flexible delivery service.

ESG Impact of SIG Acquisition



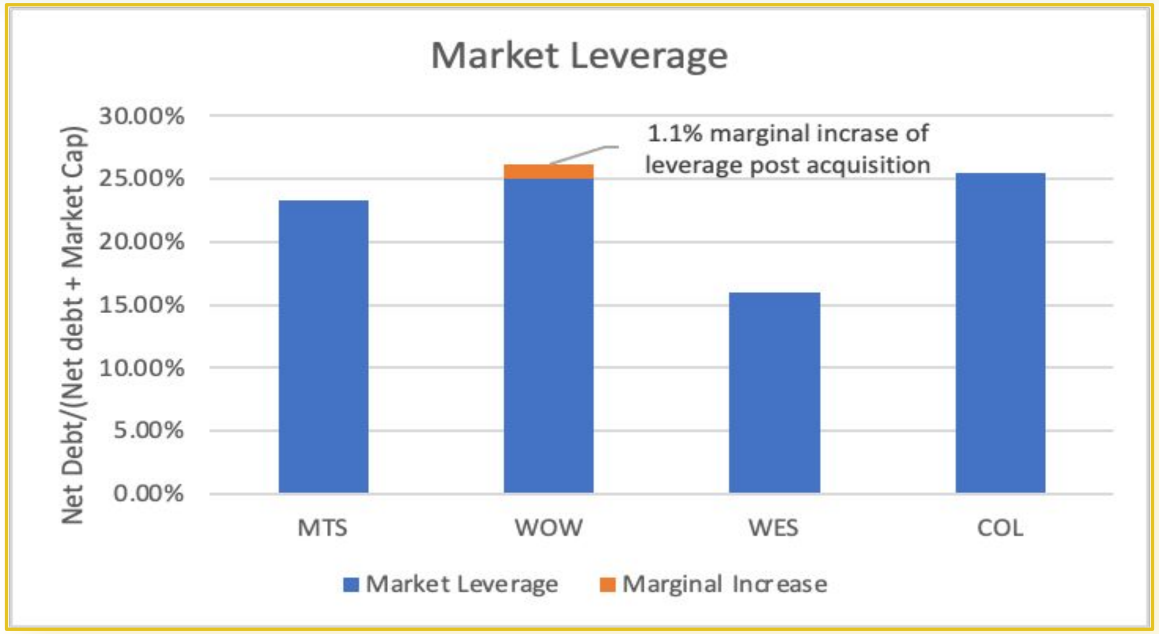
- **Social Impact:** Growth opportunities allow WOW to provide pharmacies and medicines accessible to more Australians.
- SIG enhances Woolworth's brand and mission (similar to the Endeavour demerger).

ESG Risks of SIG:

- Sigma are not exposed to high levels of material ESG risks
- SIG have had OH&S incidents
- Are still in the process of identifying climate and other risks and tackling potential improvements in such areas
- No material financial impact
- WOW can help alleviate any ESG risks with the help of their organisation

Scheme Arrangement and Associated cost

- We suggest an issuance of $750 million long-term secured loan with a 6.5% fixed interest rate and 10-year maturity to facilitate the execution of our recommendations. Additional expenditures will be financed by WOW’s existing liquidity.
- We recommend an offer of $0.85 per SIG share, representing a 32.8% control premium to SIG’s closing share price at 1 AUG 2022 of $ 0.64.
- The integration cost of acquiring SIG’s business is estimated to be around A$35 million.



The impact of long-term loan borrowing on WACC

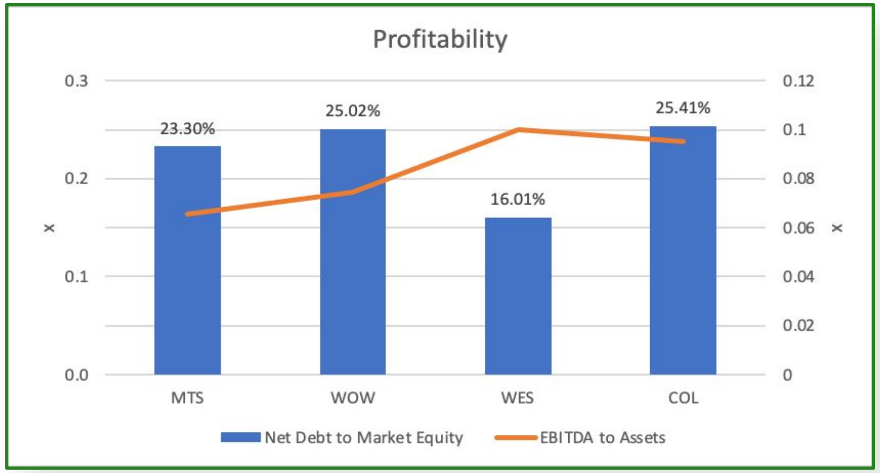
- The issuance of a $750m long-term loan will increase Woolworth's WACC from 5.78% to 5.96%.

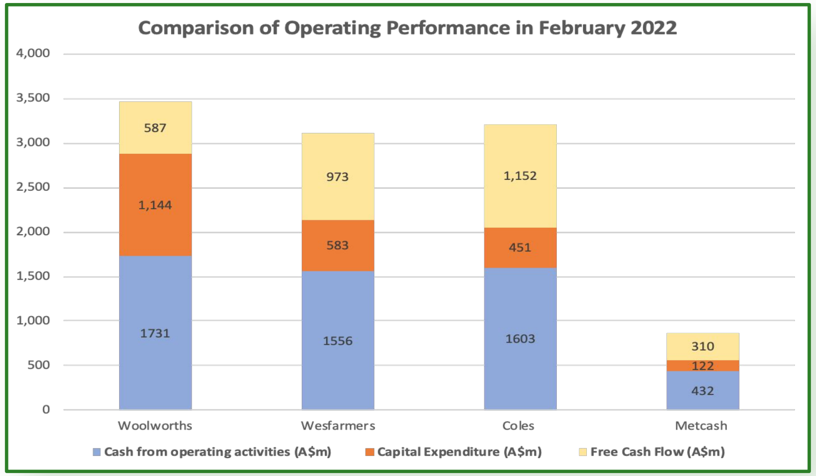
Standardised in Millions of AUD	Before the issueing	After the issuing
Market value of equity (E)	46334	46334
Market value of debt (D)	16471	17221
Proportion of equity-based financing	73.774%	72.904%
Proportion of debt-based financing	26.226%	27.096%
Cost of debt (Rd)	3.45%	4.04%
Risk-free rate (Rf)	3.415%	3.415%
Beta of the investment (β)	0.49	0.51
Market return (Rm)	10.53%	10.53%
Cost of equity (Re)	6.90135%	7.04365%
Provision for income taxes	281	281
Net income before taxes	1159	1159
Corporate tax rate (Tc)	24%	24%
WACC	5.776847%	5.964367%

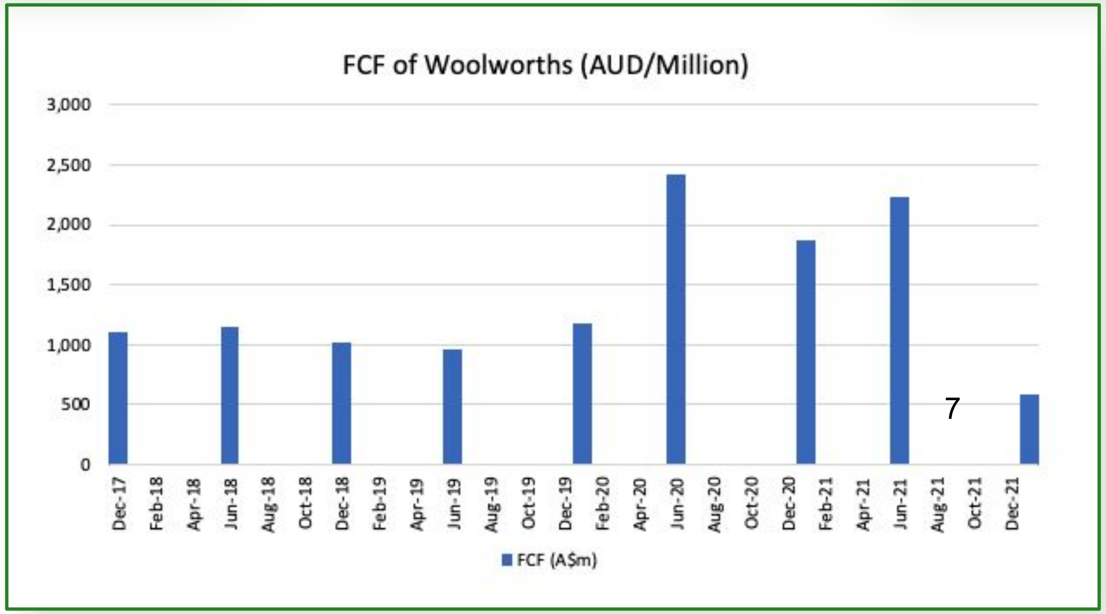
- A higher WACC typically signals a higher risk associated with a firm's operations. The company's valuation may decrease because it uses more debt and equity financing to operate.

- Although a higher WACC may seem a cause for concern, it isn't necessarily a negative mark since the company is issuing corporate bonds to fuel corporate expansion.

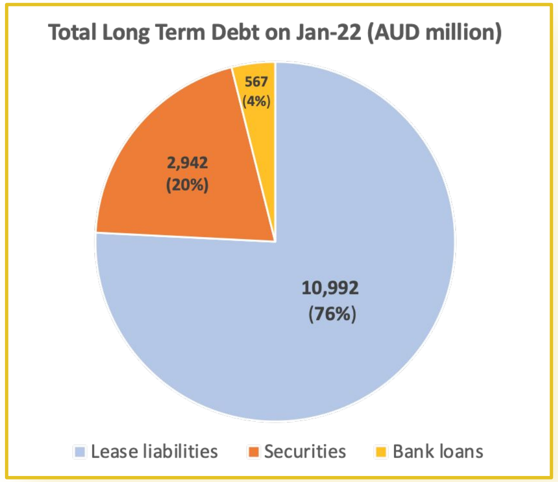
Due to severe disruption of Covid-19 on its business operations. WOW currently has a relatively low profitability and limited FCF compared with its peers. Moreover, FCF in the early 2022 has plummeted below its pre-pandemic level, reflecting its need of external financing.

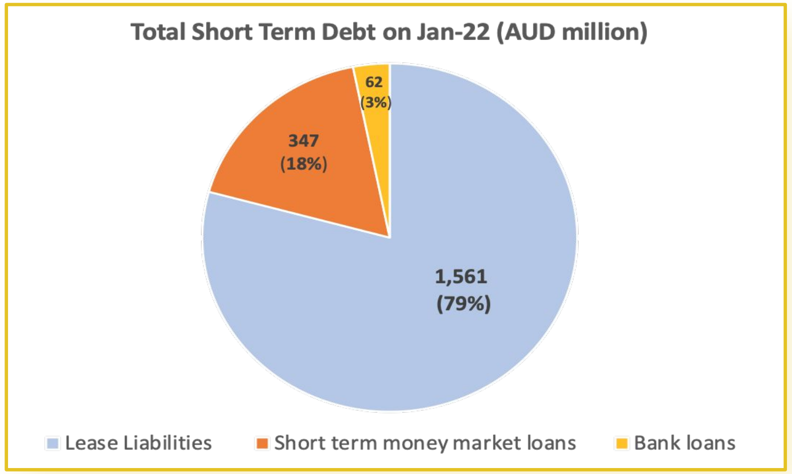


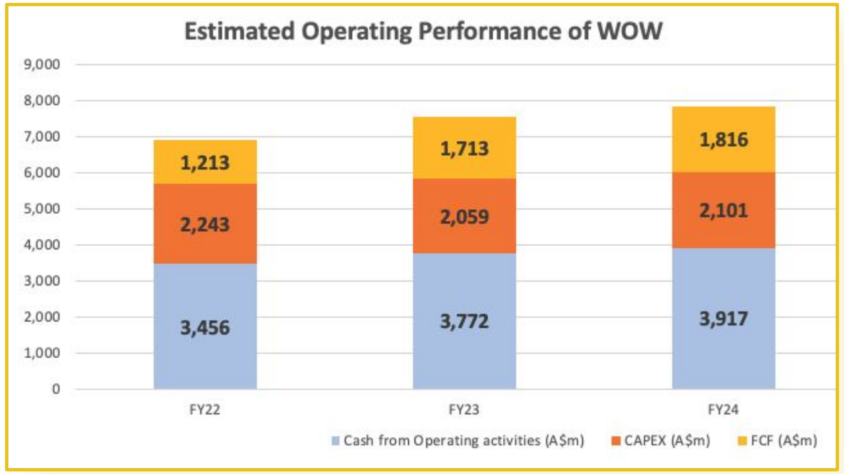


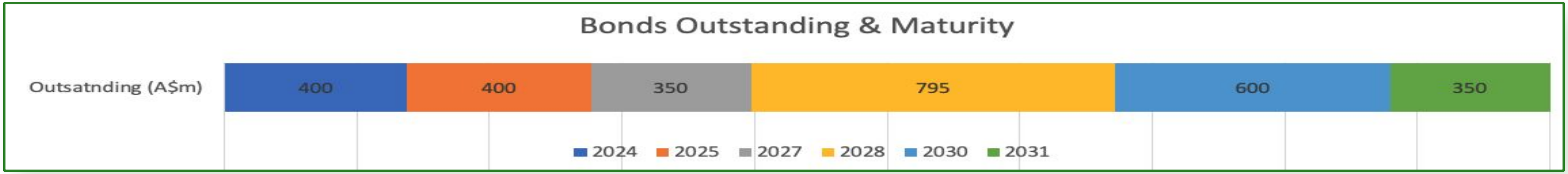


Woolworths has six bonds that will mature in the next 10 years and each maturity has a very close gap. The revenue of Woolworths is expected to increase because the market is warming up after the Covid-19 pandemic. The FCF of Woolworths was originally expected to rise by 41% and 51% in 2023 and 2024 respectively compared with the estimated free cash flow by the end of 2022. After acquisition of SIG, it is expected that its FCF performance will increase further.

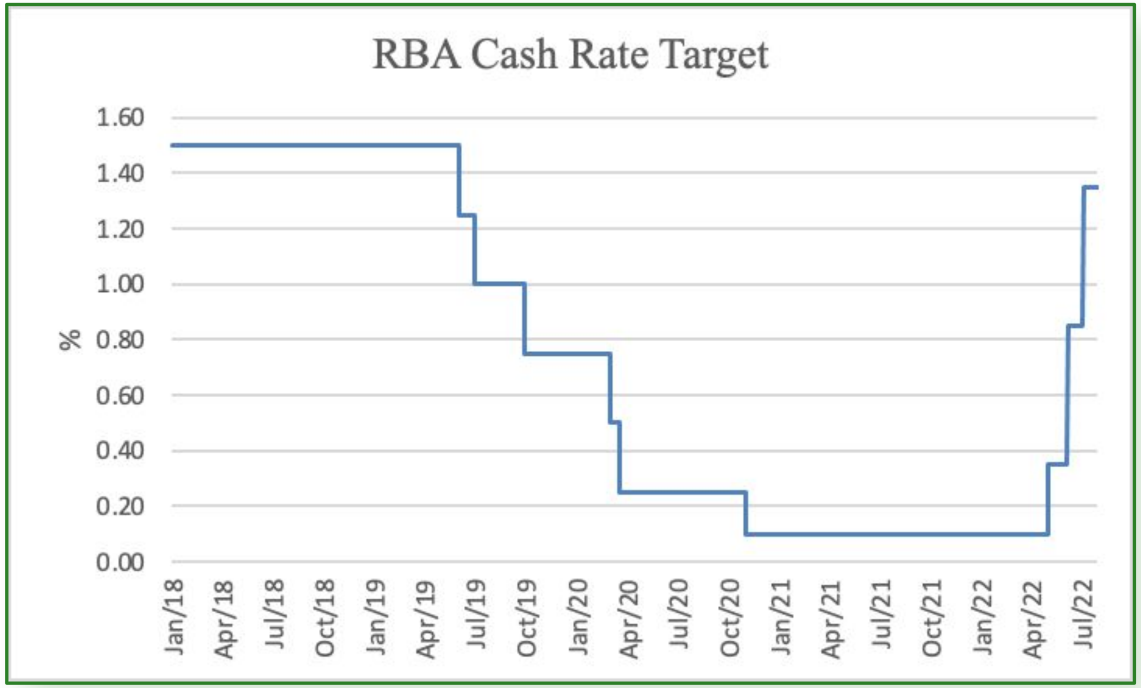


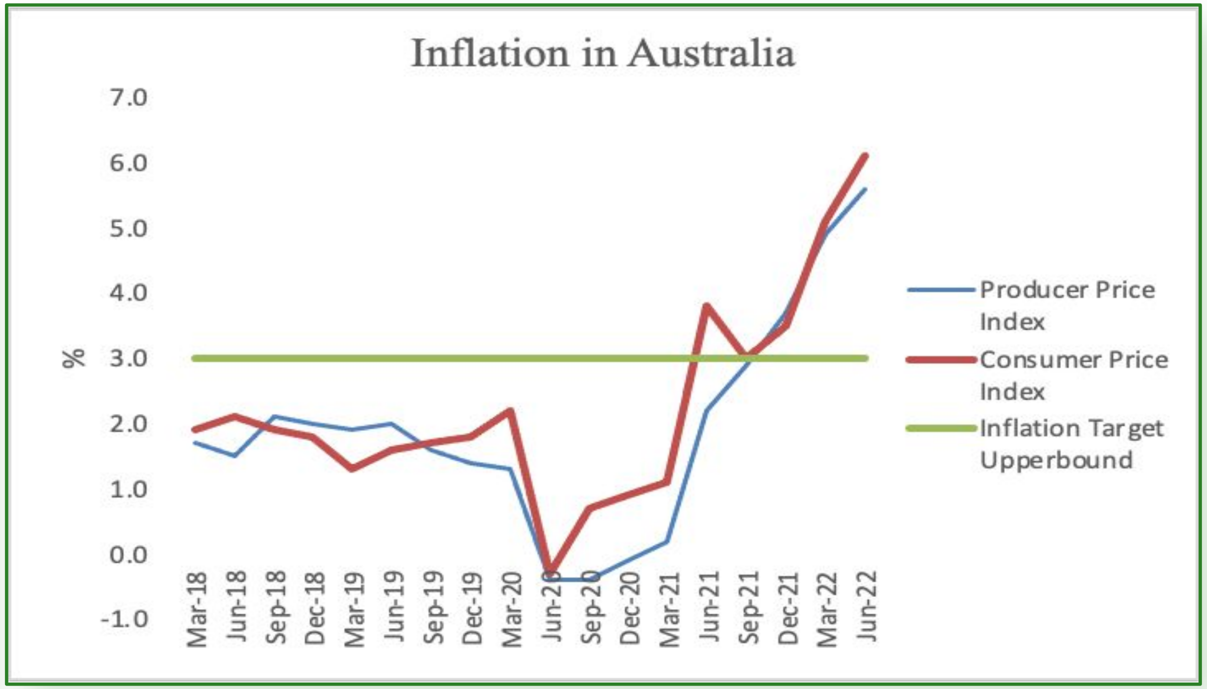




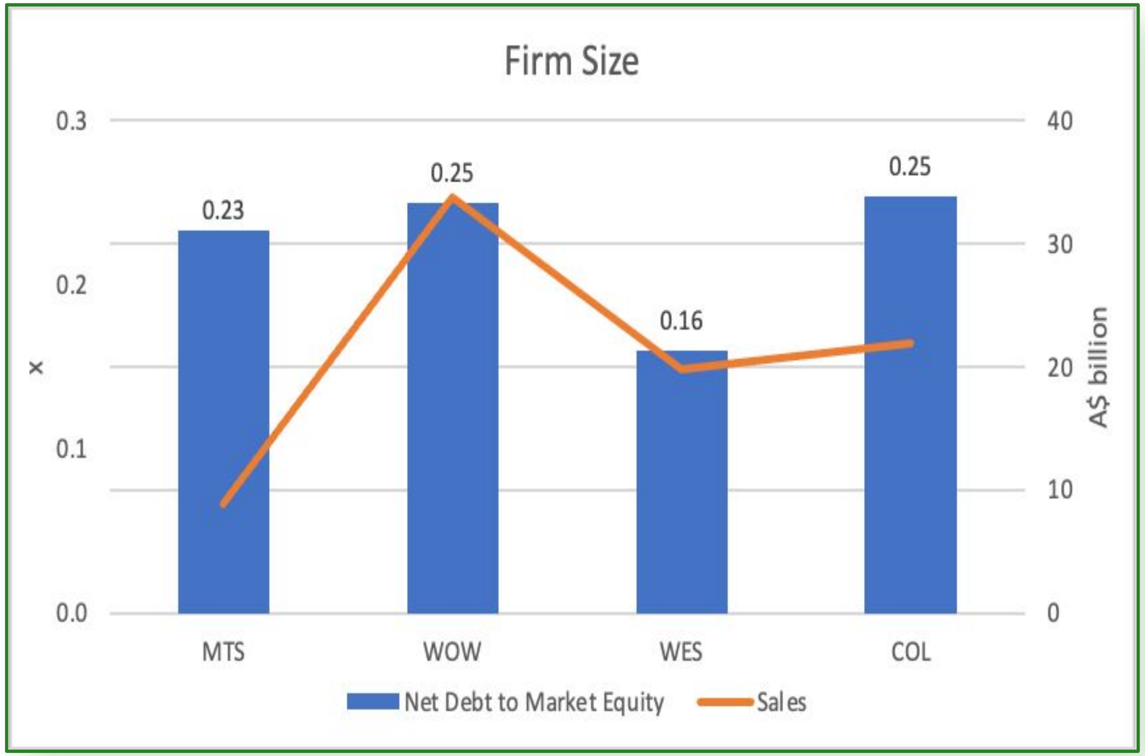


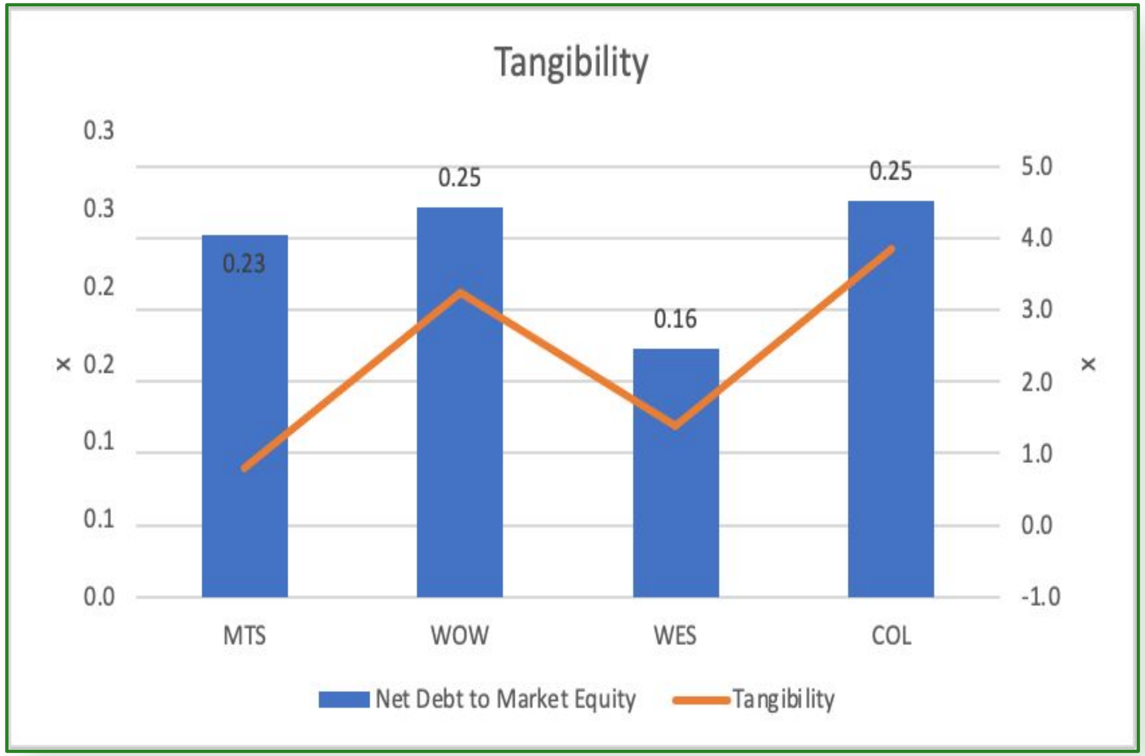
With awareness of the surging inflation felt by Australia, It is expected that RBA will keep increasing cash rate to help bring back inflation to the targeted 2% - 3%. As a result, we reckon the 750 million long-term debt issuance is urgently needed to prevent further increase in borrowing cost.



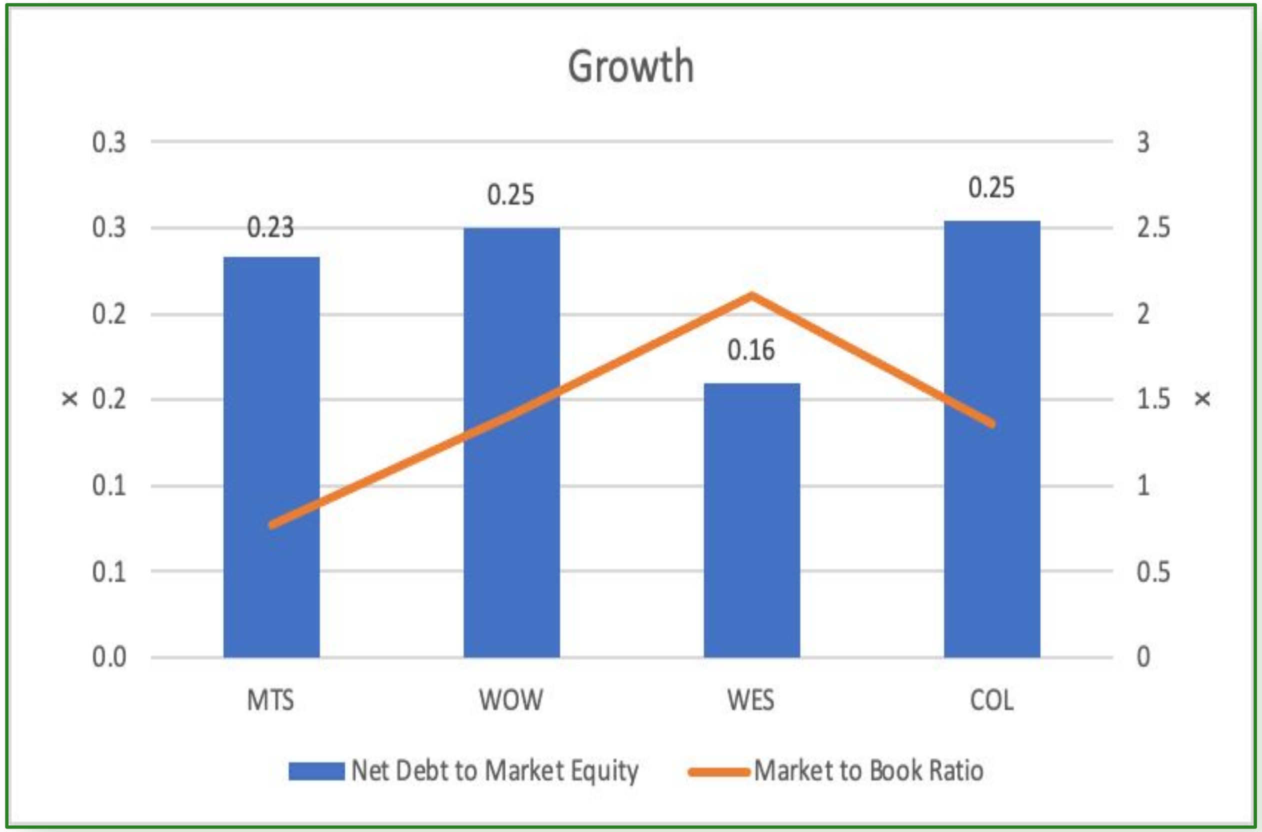


In comparison with its peers, being the largest firm and having the second highest tangibility of assets allow Woolworths to marginally raise their leverage without significant concern over material cost incurred by additional financial distress.





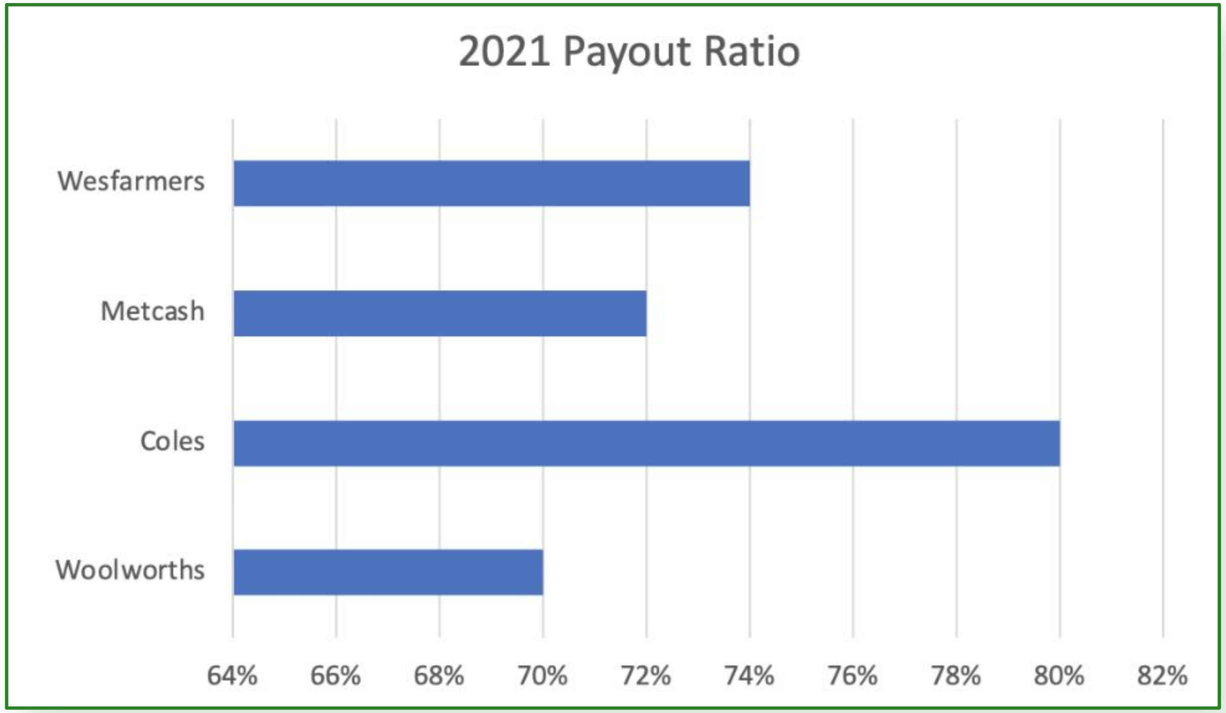
After realisation of the synergy with SIG, WOW's profitability will be boosted significantly. To align its capital structure with this strategic extension, WOW is recommended to gradually lower its leverage to reserve enough financial flexibility as a comparative advantage to capture emerging growth opportunities in the pharmaceutical industry.



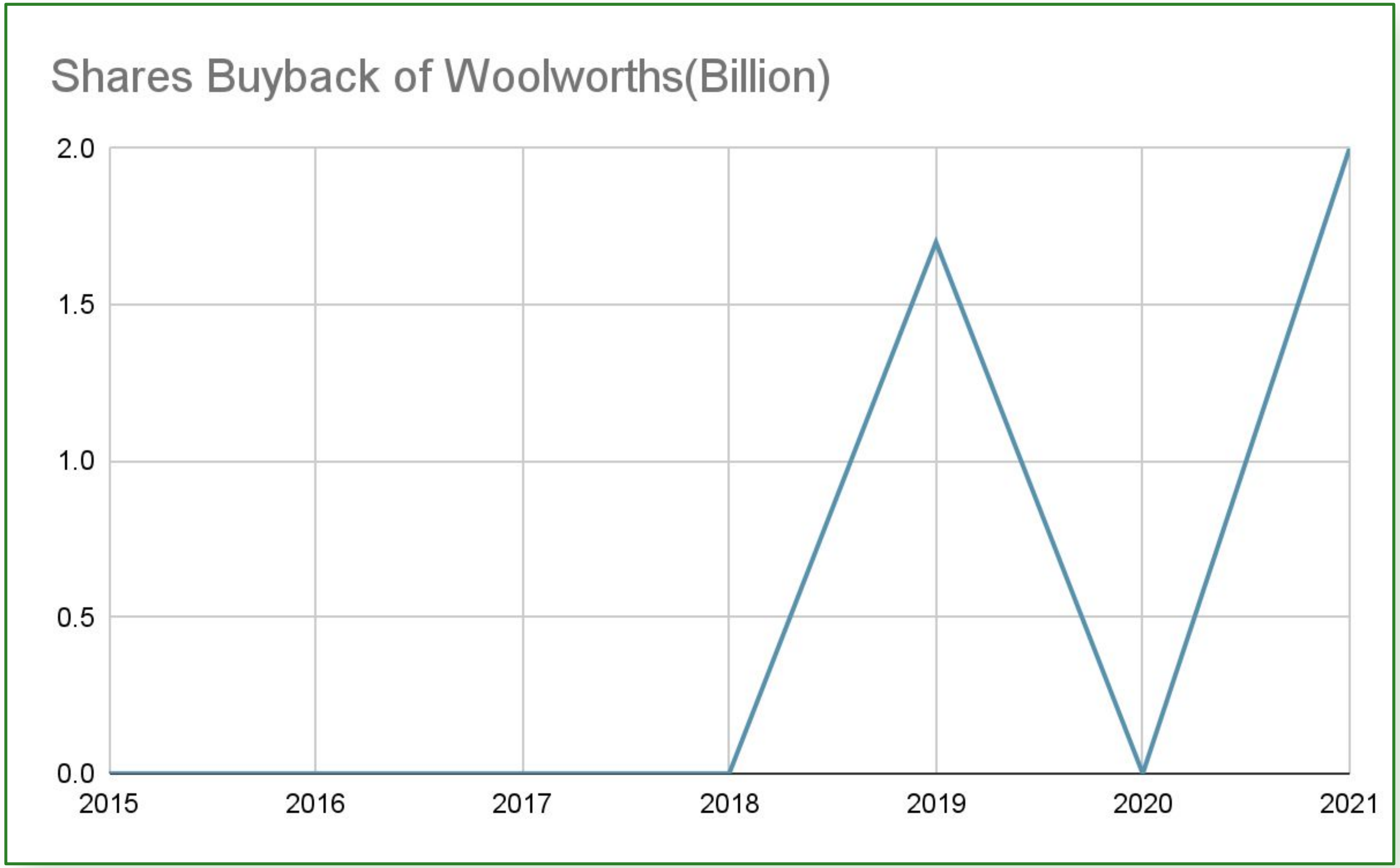
-The payout ratio of Woolworths is around 70%, which is slightly lower than its competitors (Coles: 80%, Metcash: 72%, Wesfarmers: 74%).

-According to the 2022 Broker's Report, Woolworths' net profit is expected to grow from 2023, and the dividend payout ratio is predicted to stabilize at 73.7% in 2022-2024.

-The acquisition of SIG can boost it profitability, which allows WWS to pay around 4% more dividend to its shareholders.



Following the SIG acquisition, Woolworths is not advised to buy back its shares in the short term, as it just completed a $2 billion off-market share buyback a year ago, and it has only two buybacks in its history.

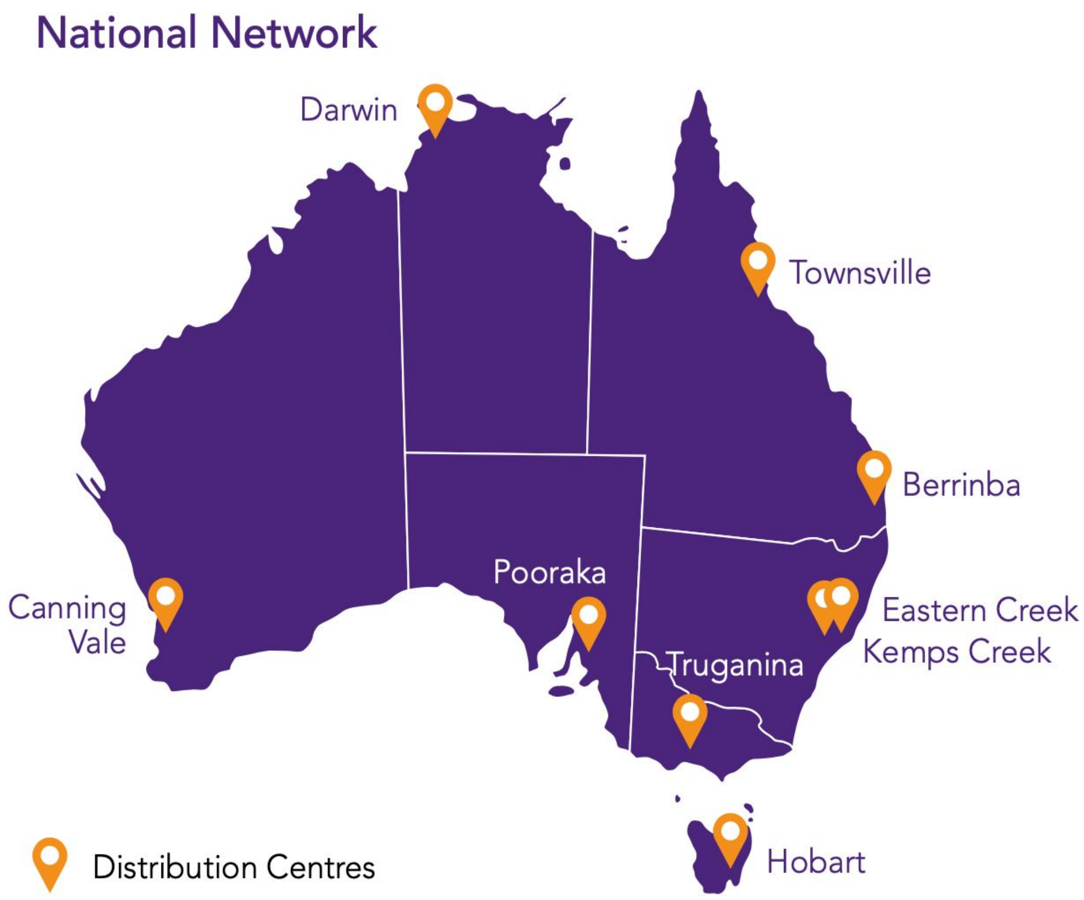


Thank you

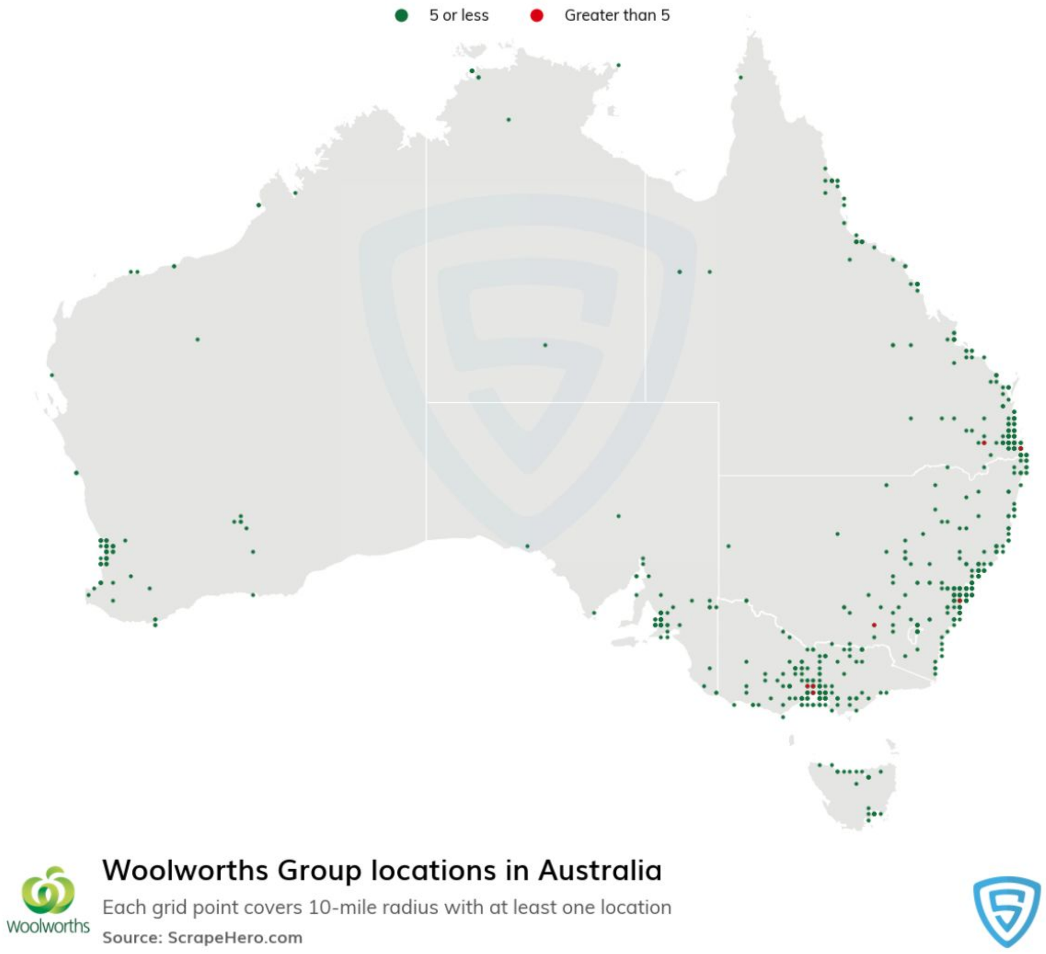
Q&A

Appendix

The map distribution centres of SIG in Australia



The Map Distribution Woolworths Stores in Australia



Sources and references to WACC formula inputs

- **Capital Structure**

  We use the firm's market cap as the value of E and total debt as the value of D.

- **Cost of Debt**

  We use the bond discount rate to estimate the cost of debt. We find the discount rates for the company's outstanding bonds and calculate their weighted average based on each amount issued. For non-Australian dollar bonds, we converted the currency into AUD using the exchange rate of 1 August 2022 before calculation. For the newly published loan, we use the interest rate to estimate the cost of debt.

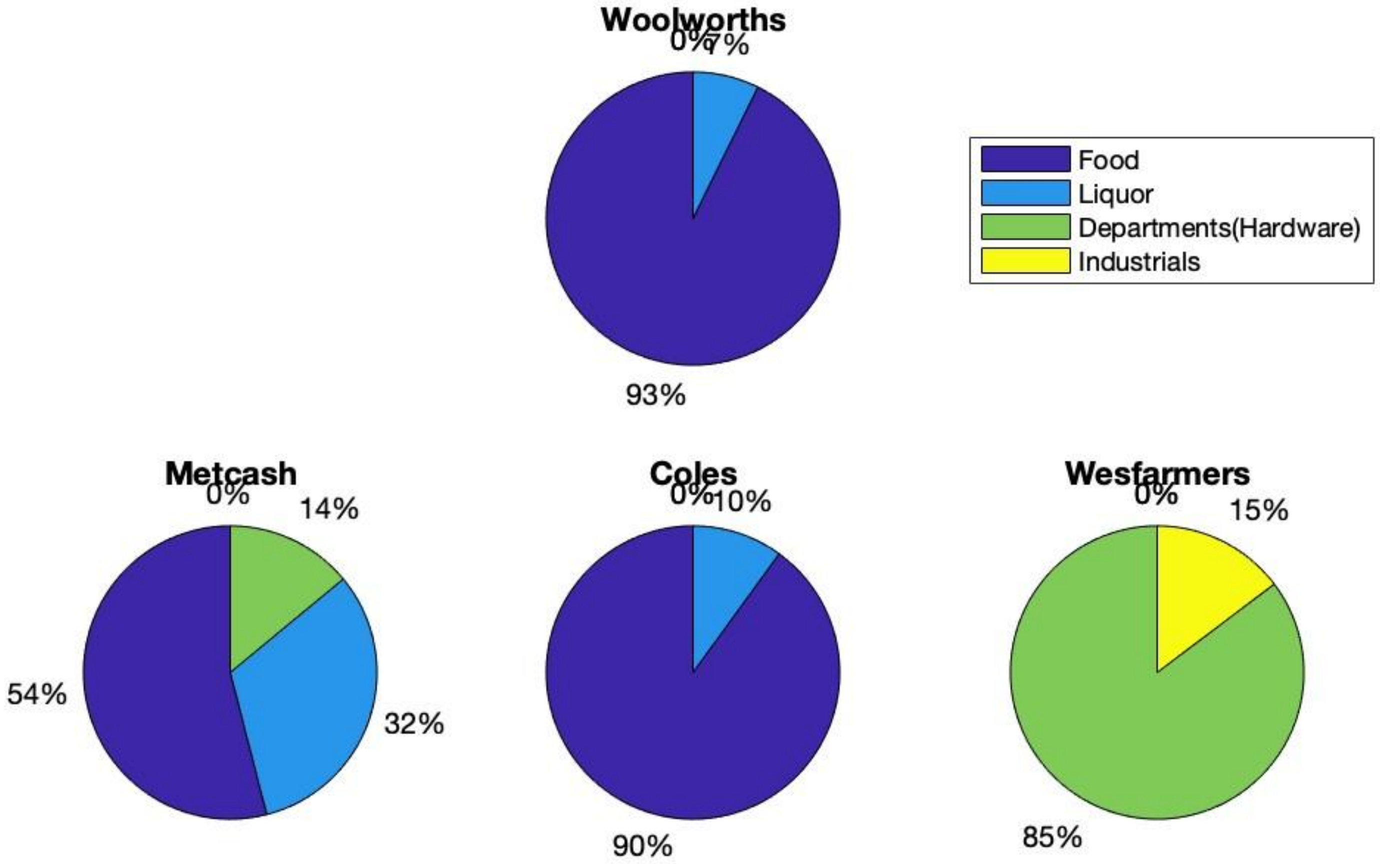
- **Cost of Equity**

  Practitioners will apply a normalized risk-free rate in determining the cost of capital if prevailing market interest rates are low. However, there are many debates about normalization. Some scholars argue that normalization is used to adjust one-time and non-recurring items, so normalizing long-term bond rates are not reasonable when developing discount rates using the CAPM. Therefore, we still apply the Australian Government Bonds rate as the risk-free rate, whose most appropriate maturity is ten years.

  As expected returns are usually unobservable, the standard approach to estimating MRP is to average realized (ex-post) returns over a long period. We use the average return of the S&P/ASX 200 Index over the last ten years to estimate market returns as ten years is an acceptable and frequently used time horizon for companies in practice to calculate market return.

  Levered β & Tax rate are from refinitiv.

Though Woolworths bears an identical business structure to Coles, sufficient focus should be put on its comparative advantage to Wesfarmers as it expanding its business into the pharmaceutical industry.



From neutrality of capital structure in Modigliani & Miller theorem to mainstream capital structure theories.

- Interest Tax Shield and Financial Distress in Tradeoff Theory

Being able to deduct tax payment from paying interest makes debt financing attractive to managers. However, increasing debt level also increases the cost of financial distress. Optimal leverage needs to be considered at the margin of benefit and cost.

- Agency Cost and Operation Efficiency in Free Cash Flow Theory

A series of problems can be incurred by the division of ownership and management. If a company is sitting on an excessive amount of free cash flow, managers can be enticed to engage in inefficient activities that do not maximise shareholders' value. With a higher leverage ratio, the interest payment obligation can help managers make more effective use of resources available.

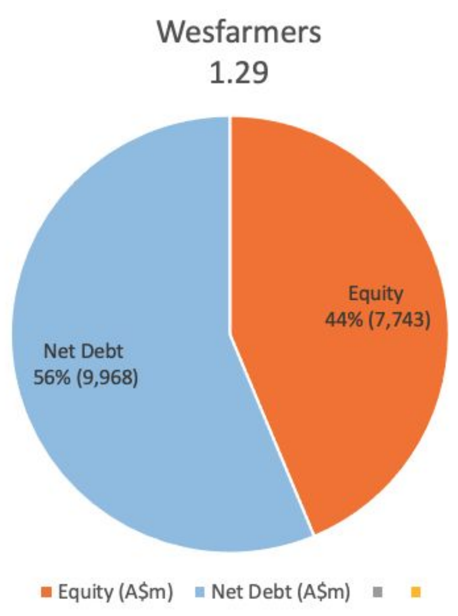
- Friction of External Financing and Financial Flexibility in Pecking Order Theory

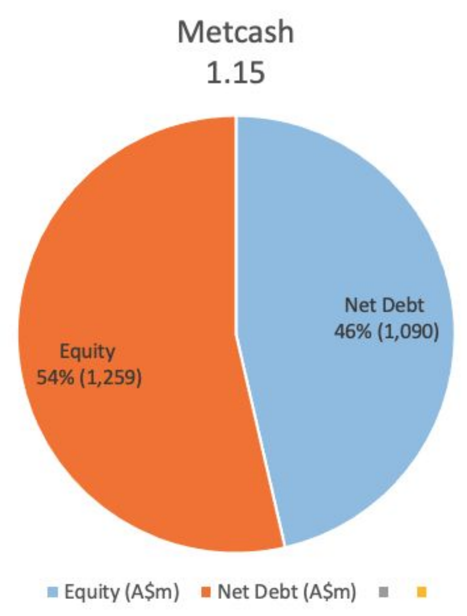
Internally generated cash is the most liquid funds to finance business activities. External financing can experience great friction especially when financial market is suffering a downturn. While less prefered, debt financing is still the second best choice since it does not incur material asymmetric information problem as equity issuing.

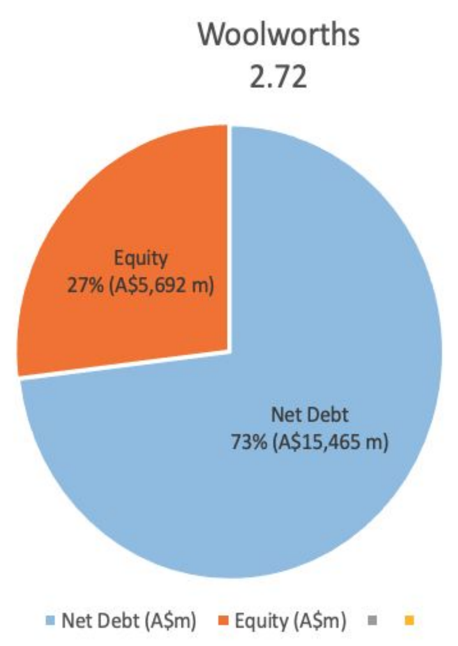
A qualitative analysis framework is developed with incorporation of the theories, linking the key interests (Column 1) with variables of firms (Row 1) that are either directly observable or can be approximated indirectly.

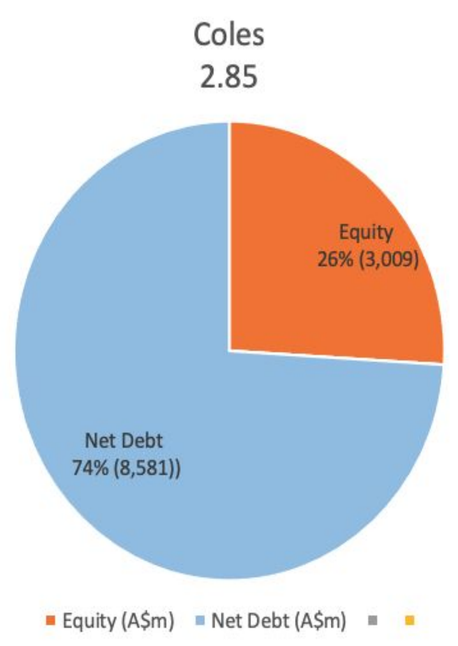
	Growth	Firm Size	Profitability	Tangibility
Net Tax Deduction Effect (+)	/	+ +	+ +	+ +
Operation Efficiency (+)	/	+ +	-	/
Financial Flexibility (-)	+ + +	+	+ + +	/
Debt Level	- - -	+ + +	- -	+ +

Ratings: / is assigned for relations that are negligible or lacking evidence from literature; + (-) is assigned for correlation that can be explained by theories but is dominated by other associated impacts; + + (- -) is assigned for correlation that is supported by theories and evidence but with limited impact; + + + (- - -) is assigned for correlation that is strongly supported by theories and evidence with no objections from other theories or concerns.









Semi-annual data by the end of Feb 2022 (Interim values)	Woolworths (WOW)	Coles (COL)	Metcash (MTS)	Wesfarmers (WES)
Market Capital (A$)	46,334	25,189	4,016	53,007
Cash and cash equivalent (A$m)	1,006	1,098	105	623
Cash from operating activities (A$m)	1,731	1,603	432.3	1556
Capital expenditure (A$M)	-1,144	-451	-121.7	-583
Free cash flow (A$m)	587	1,152	310.6	973
Operating cost (payment to supplier and employees) (A$m)	-31,225	-19,892	-8,534	-17,351
Total Debt (A$m)	16,471	9,679	1,364	10,591
Long-term debt (A$m)	14,501	8,774	1,171	8,561
Short-term debt (A$m)	1,970	905	192.7	2,030
Net D/E ratio (%)	271.7	285.18	103.99	128.74

Default Rate & CDS Premium Comparison

Company	Probability of Default	Credit Rating	CDS Premium (USD)
Woolworths	0.09%	BBB / Baa2	85
Metcash	0.07%	NA	NA
Coles	0.08%	BBB+ / Baa1	72.25
Wesfarmers	0.06%	A- / A3	57

Ratios

Ratios	WOW	COL	MTS	WES
Liquidity Ratio				
Current Ratio	0.53	0.63	1.12	0.92
Quick Ratio	0.21	0.25	0.7	0.26
Cash Ratio	0.09	0.17	0.05	0.07
Leverge Ratio				
D/E	2.89	3.21	1.21	1.36
D/(E+D)	0.74	0.76	0.55	0.58
D/A	0.50	0.52	0.25	0.42
A/E	5.77	6.18	4.77	3.26
Coverage Ratio				
Interest Coverage	3.99	4.92	9.72	12.35
D/EBITDA	6.72	9.93	2.05	3.98

Morningstar Analysis of SIG ESG Risks:

Sigma Healthcare Ltd.

Industry Group: **Healthcare**

Country/Region: **Australia**

Identifier: **ASX:SIG**

Sigma Healthcare is an Australian pharmaceutical distributor, wholesaler and pharmacy franchisor. The revenue growth prospects and returns of pharmaceutical distribution are subdued due to ongoing Pharmaceutical Benefits Scheme, or PBS, price reform, and regulated wholesale gross margins being capped at 7% for community pharmacy...

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Full time employees: **156**

ESG Risk Rating CORE ?

15.0 Low Risk

Negligible	Low	Medium	High	Severe
0-10	10-20	20-30	30-40	40+

Ranking

Industry Group (1st = lowest risk)

Healthcare **16** out of 612

Universe

Global Universe **1350** out of 14656

Other ESG considerations

Issue # 1: Underpayment of staff

- Substantial news coverage
- **Wrong** disclosures of the underpayment amount in 2019
- Incurred in excess of $160m in interest & other remediation charges → represents a meaningful financial impact
- Avoidable with extra management training

Issue # 2: Electricity usage of stores

- Woolworth's uses around 1% of Australia's total electricity
- Largest contributor to greenhouse gas emissions
- Invest in solar energy for individual stores and make them self-sustainable
- Save on electricity, which is the 3rd highest expense, after labour & rent.
- Avoid increasing borrowing costs of SLBs (which are performance based)

Costs analysis of preventing future underpayments:

Current median earning	x	Weeks worked	x	No. of employees	=	Annual wage bill	x	Tax rate deduction	=	After tax cost
$ 1,209.00	x	48.00	x	60	=	$ 3,481,920.00	x	(1-30%)	=	$2,437,344.00