## Review Classmates: Module 4 Assignment

Review by August 10, 11:59 PM PDT

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Management’s valuation of synergies



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Question 1

On September 4th, 2009 (Friday), Cadbury’s shares closed trading at 5.71 pounds a share in London. The firm had 1.37 billion shares outstanding at that point. At current exchange rates, the market valuation of the firm in dollars was 12.83 billion dollars. On the weekend of September 4th to 7th (Monday was a holiday), Kraft announced a bid for all of Cadbury’s shares. The bid, which included both cash and shares, valued Cadbury at 7.45 pounds a share. The market responded enthusiastically to the bid, increasing Cadbury’s share price to 7.91 pounds at closing on September 8th, the first day of trading following the merger announcement.

Kraft’s management was criticized for trying to buy Cadbury on the cheap. Kraft had closed trading on Sep 4th at 28.1 dollars a share, which was a full 9% below its 2001 IPO price. This lackluster stock price performance also suggested that the firm had struggled to create value from its string of acquisitions. The market was not kind to Kraft, whose shares traded at 26.45 dollars at close on Sep 8th. The firm had 1.48 billion shares outstanding.

Kraft’s management justified the merger by arguing that it would produce 625 million dollars of annual cost savings, from operations, general and administrative expenses and marketing. These annual cost savings are expected to begin a year from now, and grow at 2% a year. Even after accounting for an after-tax integration cost of 1.2 billion, and taxes of 35%, these annual cost savings could easily justify the premium offered to Cadbury, according to Kraft’s managers (even without taking any potential revenue enhancements into account). Assume that the integration cost of 1.2 billion happens right when the merger is completed (one year before the annual cost savings begin).

The food industry’s Beta is on the low side (close to 0.6), so Kraft’s cost of capital (its WACC) is not very high (around 8%).

**Compute the value of the synergy as estimated by the management.**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  |  | 2009 | 2010 | 2011 |  |
| Cost savings |  |  | 625 | … |  |
| Taxes |  |  | 219 | … |  |
| After-tax Cash flow |  |  | 406 | 414 | … |
| Integration Cost |  | -1200 |  |  |  |
|  |  |  |  |  |  |
| NPV Synergies |  | 5571 |  |  |  |

* Integration Cost = -1200
* Growing perpetuity value = 406 / (8% - 2%)
* Therefore, NPV = 406 / (8% - 2%) – 1200 = 5.6 billion dollars
* NPV of synergies as estimated by the management is 5.6 billion dollars.

See the Review Criteria section of the Instructions tab for details, then allocate points for Question #1-a below.

* **20 pts - 20 points for a complete answer that is correct. To get 10 points the student should set up the cash flows correctly, and calculate the correct NPV of the synergies**
* 15 pts - 15 points for a good answer that has calculation mistakes. For example if the student sets up the right decision tree but makes a calculation mistake to get the NPV
* 10 pts - 10 points for an incomplete answer

Question 2

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**Does the estimate of synergies in a) justify the premium that Kraft offered to Cadbury?**

* For the acquisition to be positive NPV for acquirer, the synergies have to be greater than the premium paid to the target.
* Now this is the premium that Kraft offered to Cadbury.
* Premium = (745- 571) / 571 = 30.5%
* In dollars, 30.5% \* 12.83 B = 3.9 B
* Since 5.6 superior to 3.9, in this case as long as the management is right that means Kraft generate NPV value of 1.7 billion from the acquisition of Cadbury.
* Kraft’s NPV is 1.7 billion.

See the Review Criteria section of the Instructions tab for details, then allocate points for Question #1-b below.

* **10 pts - 10 points for a reasonable answer that is consistent with the analysis in part a)**
* 5 pts - 5 points for an incomplete answer

Question 3

On September 4th, 2009 (Friday), Cadbury’s shares closed trading at 5.71 pounds a share in London. The firm had 1.37 billion shares outstanding at that point. At current exchange rates, the market valuation of the firm in dollars was 12.83 billion dollars. On the weekend of September 4th to 7th (Monday was a holiday), Kraft announced a bid for all of Cadbury’s shares. The bid, which included both cash and shares, valued Cadbury at 7.45 pounds a share. The market responded enthusiastically to the bid, increasing Cadbury’s share price to 7.91 pounds at closing on September 8th, the first day of trading following the merger announcement.

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**Did the market agree with the management’s valuation of synergies? Discuss (2 paragraphs maximum)**

The stock price decreased from 28.1 to 26.4, a decrease of 5.9% of the market agreed with the management’s view. In dollars, Kraft lost 2.4 billion dollars in equity value. The market view of the merger did not agree with the management which is a very common situation.

Then, the market suggest that the synergy associated with this deal is lower than the premium that Kraft is paying Cadbury’s price went up to 7.91 pounds, which is higher than the value of the offer of 7.45 pounds. Market expects Kraft to end up paying more it means paying 19 B, a premium of 48%.

See the Review Criteria section of the Instructions tab for details, then allocate points for Question #1-c below.

* **10 pts - 10 points for a reasonable answer that is based in the mini-case data and the arguments in the lectures**
* 5 pts - 5 points for an incomplete answer

Question 4

Discuss the following statement: “US companies have a lot of excess cash on their balance sheets. Thus, we expect merger activity to increase (because firms must find ways to use their cash). In addition, these mergers (which should be mostly funded with cash holdings) are expected to be value-enhancing for acquirers.” (1 paragraph)

This statement is probably fair and credibility is attractive insofar rich societies tend to get new acquisitions. They focus only on increasingly acquisitive . They acquisitive in nature. But these ways of acquisitions are not necessarily useful and better for shareholders. Managers should be aware that a lot of money to spend in excess is bad when you want to make a deal.

See the Review Criteria section of the Instructions tab for details, then allocate points for Question #2 below.

* **10 pts - 10 points for a reasonable answer that is based on the arguments that we discussed in the lectures**
* 5 pts - 5 points for an incomplete answer

Question 5

A company with virtually no debt, stable cash flow, and moderate growth prospects has become the target for a private equity acquisition (LBO). The company’s CEO is concerned that an LBO may result in significant job losses, given the track record of this particular PE fund. Which advice would you give to the CEO? (1 paragraph)

Private equity funds have to be dependent upon restructuring or undervaluation to produce value (no usual synergies). The CEO may try to restructure herself and increase shareholder. Increasing leverage is considered as help since private equity funds count on debt to finance to finance deals. Other reaction of the CEO to consider is to increase the leverage job of companies to make more difficult for the private equity fund to do the acquisition.

See the Review Criteria section of the Instructions tab for details, then allocate points for Question #3 below.

* **10 pts - 10 points for a reasonable answer that is based on the arguments that we discussed in the lectures**
* 5 pts - 5 points for an incomplete answer

Question 6

Yahoo holds a large stake in Alibaba Group Holdings, a Chinese e-commerce company. The value of this stake has been estimated to be greater than 30 billion dollars. Yahoo’s market capitalization is approximately 35 billion dollars. According to Capital IQ, Yahoo’s Beta is 1.11. Would it be appropriate to use Yahoo’s Beta to compute the cost of capital for Yahoo? Why or why not? How would you estimate a WACC for Yahoo? (2 paragraphs)

* Yahoo’s business belong to Yahoo because Yahoo’s business is a small part of Yahoo otherwise the better for Yahoo’s business is just more part of the Yahoo.
* Then, Alibaba drives most of the equity value. That’s why 30 billion dollars out of 35 billion dollars correspondent to the value of the stake of Alibaba.
* We have to know Alibaba went public very recently. Thus it is not easy to come up to the good better estimation for Alibaba. Therefore it is important to use a comparable company.
* 1.11 = Alibaba Beta\* (30/35) + yahoo Beta\*(5/35)

See the Review Criteria section of the Instructions tab for details, then allocate points for Question #4 below.

* **20 pts - 20 points for a reasonable answer that correctly discusses both whether the Beta is 1.1, and suggests a reasonable way of estimating the Beta**
* 10 pts - 10 points for an incomplete answer, for example if the suggestion to calculate Beta does not make sense

Question 7

The following data refers to Coca Cola (NYSE: KO)

* Beta = 0.5
* Required return on debt (yield to maturity on a long term bond) = 3.5%
* Tax rate = 25%
* Estimate the cost of capital (WACC) for Coca Cola.

Estimating the WACC for Coca Cola

* rE= 3% + 0.5\*5% = 5.5%
* D/V= 44 / (44+182) = 19%
* WACC = 3.5%\*75%\*19%+5.5%\*81% = 5%

See the Review Criteria section of the Instructions tab for details, then allocate points for Question #5 below.

* 10 pts - 10 points for the correct calculation of the WACC
* **5 pts - 5 points for an incomplete answer**

Question 8

How does Coca Cola’s WACC compare to Pepsico? Does this comparison make sense to you? (1 paragraph)

The capital structure of Coca Cola and Pepsico is the same. It seems that Coca Cola and Pepsico have very similar cost of capital. Those that make a lot of sense. Neither company is very risky and both companies have the same business, same leverage, same beverage, same other food product.

Therefore, the WACCs should be similar.

See the Review Criteria section of the Instructions tab for details, then allocate points for Question #6 below.

* **10 pts - 10 points for a reasonable answer that is consistent with the analysis in question 5**
* 5 pts - 5 points for an incomplete answer or an answer that is too long (longer than 1 paragraph)

Question 9

Now consider Coca Cola’s income statement and balance sheet, and compute EVA in 2014 as we did for Pepsico.

Estimating EVA for Cola Cola

* OPAT = 10,867 – 2,201
* Operating Assets = 92,023 – 8,958 = 83,065
* EVA= 8666 – 5% \* 83,065 = 4,512

See the Review Criteria section of the Instructions tab for details, then allocate points for Question #7 below.

* 10 pts - 10 points for the correct calculation of the EVA
* **5 pts - 5 points for an incomplete answer**

Question 10

How does Coca Cola’s EVA compare with Pepsico? Discuss. (1 paragraph)

**Coca Cola**

EVA = 8666 – 5% \* 83,065 = 4,512

**Pepsico**

EVA = 7,800 – 5% \* 61,783 = 4,677

Very similar values for EVA as well

These companies have very similar each other. Both have very profitable company that generate economy valuable added. They have the same cost capital. Then, it is very difficult to distinguish between Coca Cola and Pepsico just based on the number that you compute.

See the Review Criteria section of the Instructions tab for details, then allocate points for Question #8 below.

* 10 pts - 10 points for a reasonable answer that is consistent with the analysis in question 7
* **5 pts - 5 points for an incomplete answer or an answer that is too long (longer than 1 paragraph)**

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