## Review Classmates: Module 4 Assignment

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Assignment 4



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Submitted on August 8, 2016

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Question 1-A

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.**

0 1 2 3

Cost savings 625

Tax (35%) (218.75)

Integration Cost 1,200

Total (1,200) 406.25

= 406.25/(8%-2%) 6,771

NPV of synergy 5,571

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 1-B

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

It did till the market to a negative view to it . its after effect kinda eroded its shine.

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 1-C

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

The market had mixed feelings on the valuation of synergies. although the shareholders of Cadbury felt the transaction was great for the future prospects of the company, KRAFT shareholders thought the synergy valuation was not enough to warrant value for them especially after a spate of falling value as reflected by the stock price.

the markets reaction is reflected by the increment of the share price of Cadbury and the fall in Krafts share price

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 2

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 is a recipe for disaster given the study of Hartford which specifically agrees with the position that the suggestion of excess cash catalysing Mergers only goes to destroy shareholder value. What matters is whether the merger generates synergy of (NPV>0)

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 3

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)

It is more a case of synergy and value that attracts a company to be a target of acquisition and not a case of victimisation. Economies of scale Industry consolidation and market power Mergers, Economies of vertical integration and Eliminating inefficiencies (such as poor management) will more likely be the acquirers target

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 4

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)

Not exactly. The risk associated with yahoo is both its beta and a percentage of the beta of Alibaba. Although the beta for yahoo will fairly measure the performance of Yahoo as against the market index it does nothing to measure the risk associated with its investments in the associate company Alibaba which is also listed

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**

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.

* WACC= rd\*(1-t)\*D/V +re\*E/V
* = 3.5%(1-0.25)\*44553/226905 +6%\*182352/226905
* = 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 5

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

Both Coca Cola and Pepsico range between the 5.5% - 6.5% cost of capital which makes sense given they are competitors in the same industry. Given the same level of risk as identified by the Beta of 0.5% its only fair that a correlation is established despite the change in current bond rate.

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 6

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

EVA= OPAT- (WACC \*Operating Assets)

= 8,666- (5%\*70,334)

= 5,149.3

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 7

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

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Pepsico and Coca Colas EVA are both within the same range between 4 billion and 5 billion dollars each. Meaning they both generatie sufficient profits to cover its cost of capital.

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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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