A Bid for Bell Canada Enterprises

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Introduction

Bell Canada Enterprises had just announced publicly that two separate consortiums of private equity players – (1) Kohlberg Kravis Roberts Co. (KKR) and the Canadian Pension Plan Investment Board (CPP), and (2) Providence Equity Partners (Providence) and Ontario Teachers' Pension Plan (OTPP) – were interested in a potential transaction involving BCE. After months of trying to downplay rumours, BCE realized a major change was inevitable. Its stock price had risen 26 since the rumours of a potential change of control had started in November 2006. Possible strategic alternatives that BCE was considering included being taken private by financial buyers, a merger with Telus, the second-largest telecommunications company in Canada, or the implementation of changes but under the current ownership structure.

This case study involves the synergies that the two buyers financial and strategic would enjoy by a M&A of BCE and valuing the merged corporations involving a possible Leveraged Buyout Option.

Bell Canada from a Strategic Buyer's Perspective

Telus, the largest telecommunications company in Western Canada and second-largest in the country, joined the auction in early May 2007.Telus had long been seen by some of the most senior managers at BCE as the preferred partner in any merger or acquisition deal, given the fit between the two operating companies. The opportunity to acquire or merger with BCE provides tremendous opportunities for Telus as a strategic buyer.

Firstly, Telus was the second largest telecommunication organization available in the industry and was a major competitor of Bell. Hence, Telus could also be considered as a strategic buyer in which, the company decided to merge with BCE to induce synergies in its business objectives Which would enable Telus to enhance its own brand image and position in the market. The merger would yield extensive financial and strategic synergies and could provide a platform for growth domestically and potentially internationally. From a regulatory perspective, such a merger would be an appealing "Made in Canada" solution.

Furthermore, Telus could be able to use the strong market position of BCE in its wireline, wireless and media market segments, where BCE hold the leading position in those market segments.While using its already established business model and strategies that had benefited BCE in the past and allowed it to gain significant share in the market. Moreover, a combined Telus-BCE could save on capital investments. Telus and BCE's capital spending overlapped in areas of RD, network upgrades and wireless investments.

Therefore, it can be assessed that these strategies implemented by BCE and its efficient business model would hugely benefit Telus, in enhancing its position and profitability in the market and better align itself with its own strategic objectives set by the senior management of the company. Nevertheless this merger will also add value for BCE in the follwing ways:

Industry observers estimated the companies could save around $1 billion in annual costs within five years by merging the wireline businesses, corresponding to a drop in operating costs/sales of approximately five percentage points for BCE. They would not need as many call centres, phone stores, billing operations or service staff when operations overlapped.

As one, Bell Canada and Telus would capture more than 50% of wireless subscribers in all but two provinces. In 2006, Bell's wireless unit earned 18% less revenue per user than Telus, largely due to lower average revenue per wireless user (ARPU). Some felt that Telus could close this gap within five years by migrating some of Bell's low ARPU customers to Telus' phone plans that generated higher ARPU, and grandfathering some of BCE's low-value wireless plans. The improvement in wireless ARPU could increase annual revenue for BCE by 4% in the first year and then generate an incremental annual revenue growth of 1.5%. Telus' capital intensity ratio (capital expenditures-to-sales ratio) in 2004-2006 averaged 14%, while BCE's was close to 17%. If the companies joined, it was expected that BCE's capital intensity ratio could be cut down to Telus' historical levels within five years.

Bell Canada from a Financial Buyer's Perspective

Bell Canada was the leading telecommunication organization in Canada. BCE's cash position and stagnant performance were highly attractive. It had significant enhanced cash flows and position in the market, through the implementation of effective strategies which, in turn, had enabled the company to secure significant share of the market. Therefore, it can be evaluated that, for private equity firm considering to acquire BCE as a financial buyer,could potentially benefit from the deal where, they would acquire majority or controlling interest of the organization in the hopes of gaining higher return on equity.

The PE firms believed that under their ownership they could make the sort of changes to BCE that the current management team, which only owned 0.2% of the shares outstanding, 52 couldn't – or wouldn't – do while it was a public company. In order to meet quarterly performance targets, public companies often feel pressured to focus on short-term earnings rather than long-term value creation. PE would reinforce the focus on value creation by increasing the incentives using stock options and bonuses which were designed to roughly double the benefit from an increase in the share price relative to the status quo – plus make such benefits available down to the Director level (rather than the one level higher VP level for the existing incentive scheme). The PE firms estimated that a combination of a leaner management structure with headcount reduction would result in an improvement of BCE's SG&A-to-sales ratio (selling, general and administrative expenses) by three percentage points within two years.

To reduce CAPEX, the PE firms were expected to follow three guiding principles:
i) Cost restructuring, especially in IT and Network. (a lot of capex projects weren't properly providing true NPV and there were opportunities to reduce them).
ii) Developing cross-business unit platforms (e.g. reducing redundant investments across business units (BU) and reviewing expenditures more closely to identify opportunities that could benefit multiple Bus).
iii) Adopting a "pennies count" mentality From an operational standpoint, private equity firms were expected to improve working capital management, back to BCE's 2005 level, i.e., –8% of revenues 59 instead of –1% for 2006. PE firms plan to review payment terms across the company (dealers, procurement, handsets) and to implement more favourable terms with the vendors (that prolongs the use of cash). They were also focusing on inventory management by reducing the number of handsets and other tech devices carried, resulting in streamlined and relevant (higher turnover) products.

' Furthermore, as a private company, BCE would benefit from additional SGA savings (estimated at 0.3% of sales) by being delisted. BCE required minimum effort from these PE firms to maintain its current market position and profitability. However, the PE firm could potentially further enhance the profitability of BCE by focusing on long-term value creating, while operating as a private company in the market which, in turn, would allow them, to gain significant returns from their investment, which was acquired through leveraged buyout in the form of loan or bonds from venders. The PE firm would easily be able to pay-off the loan amount plus interest, which could be attributed to its past performance or its future performance after focusing on its long-term value creation alternatives while making decent profit in the form of higher return on equity for themselves in the process and enhance their own image, position and secure a fair share of the market as well.

Standalone DCF of Bell Canada

The beta for BCE is 0.7. The risk free rate is 4.1% and the EMRP is 6.9%. Using this we get the equity cost of capital to be 8.93%. The debt cost of capital is 6.7% and the Debt/Value ratio is 47.027%. The corporate tax for BCE is 28.5%. Using this information we can calculate the WACC for BCE:

$$r_{WACC} = \frac{E}{E+D} * r_E + \frac{D}{E+D} * r_D * (1 - \tau(c))$$
$$r_{WACC} = 0.53 * 8.93 + 0.47 * 6.70 * (1 - 0.285) = 6.983\%$$

Using the revenues for year 2006 and incremental growth of revenues at 0.5% we get the revenues for the years 2007-2011. I used the Key Financial Metrics given for the year 2006 as a proxy for all calculations. The sale of Telesat has been recorded in the year 2007 and the terminal value has been computed as 7 times the EBITDA. The WACC has been used to discount the Cash Flows. Corporate Tax of 28.5% has been used for BCE. The DCF analysis for Bell Canade Enterprises follows:

	Standalone DCF for BCE					
	2006	2007	2008	2009	2010	2011
Revenue	17,255	17341.275	17427.98138	17515.12128	17602.69689	17690.71037
CapEx (17.1%)	2950.605	2965.358025	2980.184815	2995.085739	3010.061168	3025.111474
EBITDA (40.7%)	7022.785	7057.898925	7093.18842	7128.654362	7164.297634	7200.119122
Amortization (17.8%)	3071.39	3086.74695	3102.180685	3117.691588	3133.280046	3148.946446
EBIT	3951.395	3971.151975	3991.007735	4010.962774	4031.017587	4051.172675
Tax (28.5%)	1126.147575	1131.778313	1137.437204	1143.12439	1148.840012	1154.584212
EBIAT	2825.247425	2839.373662	2853.57053	2867.838383	2882.177575	2896.588463
Change in WC (2%)	345.1	346.8255	348.5596275	350.3024256	352.0539378	353.8142075
Extaordinaries		1890	0	0	0	50400.83385
FCF		4503.937087	2627.006773	2640.141806	2653.342515	53067.44308
Discount Rate		1.069833173	1.144543019	1.22447009	1.309978722	1.401458693
Discounted FCF		4209.943381	2295.245115	2156.150508	2025.485201	37865.86315
Present Value=	48552.68735					
Extraordinary for 2007 is the sale of Telesat and for 2011 is the terminal value which is 7 times EBITDA						

Figure 1: DCF Analysis for BCE

The present value of the firm turns out to be $ 48.552 Billion

DCF of Bell Canada Post Merger with Telus

The CapEx as expected would decrease from 17.1% to the historic Telus levels of 14.1%. Also as the Operating Costs would decrease by 5 percentage points (due to lesser number of call centres etc.), we can safely account this as an increase of EBITDA from 40.7% to a 45.7%. Also the Revenue is expected to increase by 4% in the year 2007 and 1.5% thereon. Using these updated ratios, we again do a DCF analysis of Merged BCE:

	BCF after Merger					
	2006	2007	2008	2009	2010	2011
Revenue	17,255	17945.2	18214.378	18487.59367	18764.90758	19046.38119
CapEx (14.1%)	2432.955	2530.2732	2568.227298	2606.750707	2645.851968	2685.539748
EBITDA (45.7%)	7885.535	8200.9564	8323.970746	8448.830307	8575.562762	8704.196203
Amortization (17.8%)	3071.39	3194.2456	3242.159284	3290.791673	3340.153548	3390.255852
EBIT	4814.145	5006.7108	5081.811462	5158.038634	5235.409213	5313.940352
Tax (28.5%)	1372.031325	1426.912578	1448.316267	1470.041011	1492.091626	1514.473
EBIAT	3442.113675	3579.798222	3633.495195	3687.997623	3743.317588	3799.467351
Change in WC (2%)	345.1	358.904	364.28756	369.7518734	375.2981515	380.9276238
Extaordinaries		1890				60929.37342
FCF		5774.866622	3943.139621	4002.286716	4062.321016	65052.62925
Discount Rate		1.069833173	1.144543019	1.22447009	1.309978722	1.401458693
Discounted FCF		5397.913213	3445.165063	3268.586753	3101.058779	46417.79995
Present Value=	61630.52376	Discounted for 2 years=		53850.61549		
Extraordinary for 2007 is the sale of Telesat and for 2011 is the terminal value which is 7 times EBITDA						

Figure 2: DCF Analysis for BCE post merger

We get the present value to be \$ 61.63 Billion, but we need to realise that these changes are not effective instantaneously hence we need to discount them by atleast 2 years to get the correct present value of \$ 53.85 Billion.

The value of BCE has increased by (53.85 - 48.552) = \$ 5.298 Billion.

The value of Telus is expected to remain roughly the same given no major change in operating ratios take place for it post merger. Assuming the value of Telus to be "X", we get:

Pre-Merger Total Value = 48.552 + X
Post-Merger Total Value = 53.85 + X

The present value of synergies from the merger occur primarily due to increase in operational ratios and reduction of competition. The value of the synergies = \$ 5.298 Billion. Therefore this merger is a NPV project for BCE.

Acquisition of BCE by PE firms by a LBO

PE firms had the firms managerial improvements as the targets for improvements. The various measures suggested by PE firms could significantly reduce Operating costs and in turn increase BCE's value. However, quantifying these changes is difficult. We can assume that Providence or other equity firms can expect a similar synergy as observed by a merger with Telus. With this in mind, maybe Providence can expect to recoup the hefty premium it is willing to pay. And using the aid of Pension funds within Canada, it can also easily pass the foreign investment barriers it would have faced otherwise. So a LBO by Private Equity firms like Providence in partnership with a Canadian Pension company is expected to be a NPV project even after the hefty premium as the synergies realised are much higher.

Conclusion

Bell Canada Enterprises should welcome the M&A proposals as the company would benefit from both type of buyers financial and strategic. The fact that the stock prices increased by 26% when the news that BCE is in play broke out clearly suggests that the Market is realising this as well. The shareholders want better operating ratios and a more vested management on the top and the M&A proposals are likely to do that for them.