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| Case 5: HCA Inc. LBO |  |
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|  | 4/21/21Financial Case Studies |
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|  | Answers to Case Study Guide QuestionsThe management team of HCA Inc. has identified uncontrollable conditions that have been eroding profitability recently (Volume of uninsured patients as well as the bad debt related to these patients). With knowledge of impending disappointing quarterly results that will cause their stock price to fall by an estimated 10-12%, management has decided that exploring a buyout with maximal share premium will be the most efficient way to create value for shareholders.  1. HCA Inc. is a health care operation company, owning upward of 250 facilities across the United States and Europe. HCA Inc. saw increased profitability in 2005, up to $1.4B from $1.2B in 2004. However, analyst projections have been too optimistic and management has missed estimates in 8 of the previous 13 quarters. This can be primarily attributed to unanticipated growth of HCA Inc.’s bad debt expense account, driven by increased intake of uninsured patients. By agreeing to a leveraged buy-out, HCA Inc. can cash out its shareholders above market value, rather than leave them to the mercy of an impending earnings miss as well as future potential earnings misses caused by an increase in the number of uninsured patients. 2. The maximum justifiable price to pay for HCA is $63.64 per share. Using APV method, we input the projected FCF (Exhibit 9, Case) as well as the terminal value (2011 EBITDA \* EBITDA Mult. Of 8). These projected values were discounted using a CAPM determined (A1) rate of back to the present year and summed to find PV of Unlevered FCFs (A2). As is with LBOs, the initial debt level is high at $27.6B and will be paid-off 14.5% annually until the management-projected 2011 debt level of $11.6B is reached. The interest expense for the next 5.5 periods as well as the terminal interest expense (found by assuming a return to industry-mean debt/equity ratio). Annual interest expenses were then multiplied by the tax rate and discounted using HCA Inc.’s cost of debt (A3) back to the start period. This figure is the present value of tax shield (A4). The sum of all PVs of tax shields (next 5.5 years + terminal value) were added to the present value of all unlevered cash flows to find total firm value (A5) (PV of NOL were not considered bc there are no foreseeable or previous NOL). Long-term debt reported on HCA’s Balance sheet (exhibit 3) and 50% of debt due within a year were subtracted from the value of the firm to calculate total value of equity. Dividing the total value of equity by number of shares, we find that a share of the post-LBO firm should cost $65.83, however, when accounting for $900M in costs and fees associated with the acquisition, we see that the maximum price per share an LBO firm should pay is $63.64. 3. The best and final offer from LBO firms is $50.75 per share. This implies a 17% premium over the current share price of $43.29. Based on management projections, stock price will fall to about $41 because of poor results in 2006. For all intents and purposes in the LBO negotiation, $41 should be considered the “non-lbo stock price”, because without the LBO, this will be the value of HCA shareholders will hold within the year. We believe a fair offer to shareholders is between a 20% to 35% premium (precedented in hospital LBOs) above $41/share, hence a range of $49.2 to $54.2. $50.75/share is well above the minimum cutoff and is therefore a fair offer. 4. We have not identified any forward-looking conflicts-of-interest related to the LBO restructuring. The LBO process changes the capital, management, and ownership structure, which may provide unforeseen issues for the rolled-over shareholders who originally invested in HCA Inc. with less risk. However, new risks are offset by the rise in equity value once the LBO is completed. The inconvenience of losing held equity for previous shareholders, is offset by the cash-out premium. 5. Acting as the Special Committee, we would recommend taking the $50.75/share offer. The offer is adequate for the exchange and management has exhausted all opportunities to improve equity value under the current capital structure. An LBO would be beneficial for the shareholders as well as the company long-term.   Appendix  A1  A2  A3  A4  A5 |  |