Financial Decision Making in a Business Context

Problem Set 4

Liddel Corp

Liddel Corporation has just closed its fiscal year by presenting the following financial accounts:

Income Statement – millions of euros	
Sales	50
CGS	31
Selling, Administrative & General Expenses (includes labor)	10
EBITDA	9
Depreciation	2,5
EBIT	6,5
Interest expense	0,25
Pretax income	6,2
Income tax	2,48
Net income	3,72

Balance Sheet – Millions of euros	
Current Assets	30
Fixed Assets	25
Total Assets	55
Payables	10
Debt	5
Equity	40
Total liabilities and stockholder equity	55

Notes:
(1) 1 million common shares outstanding
(2) Market value of debt=Book value of debt
(3) Tax rate = 40%

Liddel was founded 10 years ago by Pedro Silva as a footwear manufacturing and retailing concern. The founder is currently in talks with a private equity firm to sell the company.

You are the managing director of a local investment bank which has been retained by Pedro Silva to advise him on the transaction. You first task is to come up with a range of values for Liddell, which Pedro Silva may use as a basis for discussion.

You have gathered the following data on comparable companies traded in the stockmarket:

Name of firm	**P/E ratio**	**EV/EBITDA**	**$beta_E$**	**$beta_D$**	**Debt/Entreprise Value (at market value)**	**Expected growth rate of sales over next 5 years**
ShoeFit	20	7	1,6	0	0,313	6%
Footloose	15	9	1,55	0	0,387	5%
FashionBoot	11	6,5	1,35	0	0,11	4%

You have also gathered the following data on capital market conditions:

Risk-free rate	5%
Market risk premium	5%
Yield on AAA-rated debt	5,2%
Yield on AA-rated debt	5,5%
Yield on A-rated debt	6%
Yield on BBB-rated debt	6,5%

a. What is your estimate of value of Liddel, based on current multiples for comparable firms?
b. Develop a forecast of the free cash flow to the firm over the next 5 years. Assume that (i) the ratio of NWC to Sales, (ii) the ratio of Fixed Assets to Sales, (iii) the ratio of CGS to Sales, (iv) the ratio of Selling, Administrative & General Expenses to Sales and (v) the ratio of Depreciation to Fixed Assets all remain equal to their corresponding values in the base year.
c. Estimate the unlevered equity beta for the industry.
d. Estimate Liddel's WACC based on a target Debt-to-Entreprise Value ratio of 50% and assuming that, under such leverage policy, the company's debt will fetch an A rating;
e. Estimate the continuation value of Liddel at the end of the forecast period, using a multiples approach based on the current value of multiples for comparable firms (assume that the firm maintains its current level of debt);
f. Estimate the continuation value of Liddel at the end of the forecast period, using a discounted cash flow approach, assuming the target Debt-to-Entreprise Value ratio of 50%.
g. Estimate the value of Liddel today assuming that Liddell immediately adheres to the target capital structure. What would be, in that case, the value of the equity of the firm?
h. If the firm immediately adopts the target value for the Debt-to-Entreprise Value ratio, what adjustment in the level of the debt is required? What should be the new level of debt? What cash transactions would such a change in debt level imply?
i. Estimate the value of Liddel today assuming that Liddell maintains its current level of debt throughout the forecast period and only then switches to the target Debt-to-Entreprise Value ratio of 50%. What would be, in that case, the value of the equity of the firm?
j. What is your advice to Mr Pedro Silva on how much should he ask for the company?