SESSION 2: From accounting to FCF

After your quick but revealing insights in Total, you have now decided you want to improve your company valuation skills and apply new valuation methodologies. In order to do so you will have to further master the cash-flow concept and perform more in depth analysis of accounting statements. You have attended a brilliant Corporate Finance course where concept such as 'working capital requirement', 'net working capital', 'operating cash-flows', 'cash flows' from investment' have been presented. It is now time to apply this concept.

Q1: Coincidently, 'The Brussels Hotel Holding company' (BHHC) has been very pleased by your advice regarding their bond issue and wish to give you a new mission. It is considering various investment opportunities in various sectors but need first to have a better insight into the cash generation capabilities of the potential targets. They provide you with the following data and questions:

Tongolville seems to be a very dynamic leisure spot. After the opening of their first Tongol Palace, BHHC is considering acquiring an equity participation in an existing local player, the targeted company has the following features:

Payout ratio = 0%
Year_{t-1} EPS: 1.50€
$\text{Depreciation}_{t-1}$: 0.30€ (per share)
CAPEX_{t-1}: 0.80€ (per share)
WCR: 0.20 € (per share)
Expected yearly growth for the next 5 Y: 15%
After 5Y
LT earnings growth: 5%
WCR stable @5%
CAPEX = depreciation

Targeted debt ratio (δ: 30% (i.e. the company always issues enough new debt to fund any required principal repayments and finances its capital needs at a target debt ratio δ)

Furthermore the targeted company enjoys a very attractive tax incentive, similar to the 'Capital at risk deduction' system in Belgium, and consequently pays no tax.

a) You are asked to present the company's FCF to equity holders for the years t to t+6.

b) The current targeted δ is 30% what would be the impact on the FCFE if the company decides to enjoy a flattening yield curve ride and increase its leverage?

Q2: Actually there has been a complete management reshuffling at BHHC and there is a new CEO as well. Mitchell has a totally different background and has been brought on board to aggressively pursue the expansion strategy of the company. Part of is duty is to diversify BHHC's interests by investing in other sectors. His first target is a consumer electronics company, Nokin. The company's statements show that in 2010 the figures (in '000 €) were the following:

Revenues: 10,000
Net earnings: 1,750
CAPEX: 3,000
DEPR: 2,000
Interest charge: 500
WCR: 15% of sales
Revenues growth for the next 3Y: 10%
Long term growth 5%
Targeted debt ratio (δ: 15%
Tax rate: 50%

In its financial statements footnotes Nokin reveals that it expects the EBIT, Capex and depreciation to follow the revenues growth.

a) Mitchell wants to know how much Free Cash Flows will be generated by this company the next 4Y (2011-2014). He reminds you he wants to play big and go for the whole company.
b) After having discussed your analysis with Mitchell you notice at the very end of Nokin's annual reports 2 intriguing elements:
    1. The 2010 figures include a charge to face a potential lawsuit by Nonac who claims Nokin stole some IP. This charge is (hopefully) a onetime 100,000€ for the lawsuit which is expected to start in 2013. This amount has been paid to Mac & Mac their law firm.
    2. Years ago Nokin acquired a Korean start-up. The price paid at the time represented a significant premium to the book value which created a goodwill on Nokin's B/S. After a careful review it appears

the technology was not that great and the board has decided to write-off the goodwill in order to reflect the value loss. This creates a one-time 1,000,000 amortisation charge in 2010.

Do you believe you should let Mitchell know as these elements could impact your previous analysis?

Q3: The world of finance is a small world and the market now knows that BHHC is in a serious acquisition mode. Among them M&A bankers have nicknamed the company 'the Tongolville's whale'. And of course investment bankers are knocking on Mitchell's door with tons of proposals. Among them, Silverman Sax, a well-known house on Roof Street, has come up with 'THE PROJECT' !
The seller, a large conglomerate, wants to get rid of its retail activities. Mitchell knows very little about the sector but knows one thing. It is a very thin margin business where the cash cycle is very important: that is the working capital needs to be optimised. Following the well-known rule '*if you can't convince them confuse them*' the bankers have provided Eddy and Mitchell with plenty of data:

'THE PROJECT' B/S	**2010**	**2011**
Total Assets	**€ 2.425**	**€ 3.476**
Total LT Assets	€ 900	€ 900
Gross Fixed Assets	€ 1.200	€ 1.300
Accumulated Depr.	€ 350	€ 450
Net Fixed Assets	€ 850	€ 850
LT Investments	€ 50	€ 50
Total Current Assets	€ 1.525	€ 2.576
Trade Receivables	€ 100	€ 125
Inventories	€ 1.000	€ 2.116
Short-Term Investments	€ 25	€ 15
Cash & Near Cash Items	€ 400	€ 320
Total Liabilities & Equity	**€ 2.425**	**€ 3.476**
Total Shareholders' Equity	€ 1.300	€ 2.031
Share Capital	€ 1.200	€ 1.200
Retained earnings	€ 100	€ 831
Total liabilities	€ 1.125	€ 1.445
Long term debt	€ 650	€ 625
Short term debt	€ 225	€ 670
Account payables	€ 250	€ 150

'THE PROJECT' INCOME STATEMENT	**2010**	**2011**

Sales	**€ 22.330**	**€ 22.800**
COGS	€ 16.300	€ 17.200
SG&A	€ 3.950	€ 4.020
Depr.	€ 55	€ 100
Op.Inc	€ 2.025	€ 1.480
Other inc.	€ 1	€ 2
Int.exp.	€ 37	€ 76
Pre-tax	€ 1.989	€ 1.406
Tax (35%)	€ 696	€ 492
NI	**€ 1.293**	**€ 914**

Pay-out ratio 2011: 20%

a) Your first task is to turn the accounting balance sheet into a summarized managerial balance sheet. It should reveal more clearly the capital you employ and the net assets.
b) You are also required to compute the NWC and check its evolution over 2010 and 2011. Has the company done a good job? What went potentially wrong?
c) Funnily enough your contact at Silverman forgot to provide you with a cash-flow statement! That is no big deal for you, you master both the direct and indirect methodologies to construct a useful cash flow statement for 2011. Let's apply your advanced finance's skills.
d) In all your previous assignments you have strived to assess the FCF. Assuming the goal is to steadily acquire a majority stake in the open market before offering a squeeze out (once the regulatory threshold is reached) what is the relevant FCF to compute in 2011?
e) Is it relevant to present a single year FCF?
f) Again this time you mother is very proud of you and lets you off to have a drink in your favourite bar. This time you come across a school friend who has just done an internship at a big retailer where he did an industry wide profitability analysis. His results show an industry wide average EBIT margin of 5.84% and an EBITDA margin of 7.91%. How does 'THE PROJECT' company compare to those benchmarks in 2011? How do you interpret the comparison?
g) Sitting next to you, two newly graduated students from Smithford are loudly discussing the merits of the EBTIDA measure to assess the cash

generation capabilities of a company. Any comment you could share with them taking into account your recent work on 'THE PROJECT' ? (you have already had a couple of beers meaning your speaking capabilities are slightly altered and your eyes are shining so be very brief….)