

# Newgrade case study

Business



At the time of its \$ 770 million dollar, inception in 1988 ICC and its third-party lenders financed \$150 million to the project and the government of Saskatchewan and Canada guaranteed the capital debture (Vive, 2009). The government acknowledge that heavy oil refineries was uncharted territory but knew exploring the venture capital going forward would be a strategic investment for the future (Vive, 2009).

The strategy took an additional eight [ears to show profits in the industry because of various operational difficulties combined with depressed heavy and light crude price differentials (Vive, 2009), however, since 1996 the company have re-bounded from the losses and has been profitable every since do to royalties being paid and upgrade fuels being utilized into natural gas. As a refinery they upgrade heavy crude oils into lighter more refined crude oils, which produces manufactured petroleum products, such as gasoline and diesel fuels.

Newsreader upgrade refineries have earned the company a cash balance of \$150 million to date (Vive, 2009). In addition to the data provided limited information is known about the private company's balance sheet. Cribber the various constraints to the valuation tactic De by Newsreader: Newsreader Energy current owners Crown Investment Corporation's (ICC), Chief Financial Officer (CUFF) Blair Stunt, is evaluating the sale of 50% of the company's interest.

Before determining the sale of the company, the CUFF will need to assess the value of the company's worth in order to make a sound decision in the final analysis (Lively, 2009).

Chic's CUFF Stunt will need to address several constraints before determining the sale. Constraints associated with ENG valuations can range from factors such as business information limitations to financial information limitations to various other factors that are dependent on the company's status as a private company versus its status as a public company or startup company versus mature company. The primary constraints affecting the valuation of New Grade are influenced by unpredictability and limited financial information.

According to the case study, New Grade's earnings before interest, taxes, depreciation, and amortization (EBITDA) reflected significant fluctuations and were projected to continue as crude oil prices reflected a similar pattern (Hatch & Khan, 2011).

For example, EBITDA was \$137.36 million in 2001; \$72.5 million in 2002; \$135.79 million in 2004; \$258.06 million in 2005, and \$198.5 million in 2007, the most recent year (Hatch & Khan, 2011).

In addition, minimal to no information is provided from the company's balance sheet and income statement for the years analyzed.

Another constraint associated with the valuation of the company is commodity prices' volatility and their varying impact on the capital structure of companies in the industries. Exhibit 6 indicates that commodity prices' volatility results in firms having low to high debt-to-equity ratios ranging from 0.00 to 0.21 making it difficult to determine the Industry standard for companies similar to Newsreader.

The constraints identified above poses problems for the advisor because of the necessity of the limited information.

Individuals that specialize in valuing companies rely on three sources of information to accurately assess a business' value: current financial statements; financial history; and performance of the firm's competitors (Dominant, 2012). Each source provides vital information about a firm's overall performance and allows an analyst to compare their data to competitors to determine the reasonableness and to determine if the firm is performing below, above, or at industry levels.

Although some of these sources were provided for the New Grade valuation, multiple inconsistencies among the information and missing information make valuing the company a Challenging task. B) Describe the calculation underlying the Free Cash Flow to the Firm Method utilizing: a.

The Value of the Firm using Free Cash Flow b. The Cash Flow Forecast c. The Capital Structure The free cash flow method is used to gauge " a company's cash flow beyond that necessary to grow at the current rate... [to ensure companies] make capital expenditures to continue to exist and to grow' (Drake, n.

D. ).

Calculation of free cash flows utilizes various components, including a firm's value, cash flow forecasts, a firm's capital structure, the cost of capital, and/or discounted cash flows. Newsreader's current free cash flows may be determined by obtaining information about the firm's earnings better

interest and taxes ( T) minus the change in net working capital minus capital expenditures (Keen, n. D. ).

This information is provided in Exhibit 5 for the years 2008 through 2025. For example, in 2008, the EBITDA \$180.9 million. Deducting the capital expenditures of \$6 million and an arbitrary change in net Morning capital, which we will use as \$18. Million, the company's free cash flow for 2008 \$156.06 (\$180.

9 million – \$6 million – \$18.84 million). Cash flow forecasts are developed to determine the frequency of investors' demand, provide insight about a company's possible earnings, and to provide insight about demand plausibility for intra-temporal and cross-sectional variations in cash flows (Giving et al, 2009). The advisor was provided with the cash flow forecast for the 2008 through 2025 period; this is also available in Exhibit 5. New Grade is projected to have fluctuating cash flows for this period with \$114.

4 million in 2008; \$153.1 million in 2009; \$101 million in 2010; and cash flows of less than \$100 million between 2011 through 2021 with the highest cash flows in 2021 with \$97.5 million and the lowest in 2015 with \$74.1 million (Hatch & Khan, 2011). The firm's cash flows are projected to reach \$100 million levels again between 2022 and 2025 with \$100.

8 million in 2022; \$104 million 2023; \$107.3 million in 2024, and \$110.6 million in 2025 (Hatch & Khan, 2011). A firm's capital structure refers to its "mixture of a variety of long term sources of funds and equity shares including reserves and surpluses of an enterprise" (Preheating, 2011, p. 172).

Most companies in the industry have a capital structure that consists of low levels of debt, which is evident from the various debt-to-equity ratios of competing firms. Only one firm, Frontier, has a high debt-to-equity ratio of 21 percent while the others range from 0 percent to 3 percent (Hatch & Khan, 2011). According to the case study, Newsreader's capital structure does not include debt because a portion of the company's 1988 construction was financed by \$154 million in equity and that debt along with other associated debts were repaid, leaving it with more than \$150 million in cash, the firm's primary asset (Hatch & Khan, 2011).

C) The Cost of Capital: I. The Capital Asset Pricing Model I'.

Beta of Comparable Companies iii. Adjusting the Beta for Leverage iv. Cost Equity 1. Adjusting for a Liquidity Premium ' I. The Cost of Debt viii.

Weighted Average Cost of Capital A firm's cost of capital is similar to its capital structure because it also considers the firm's debt and equity. However, firms may use various methods to determine the cost of capital including the capital asset pricing model (CAPM), betas of comparable companies; the cost of equity; the cost of debt; and the weighted average cost of capital (WAC).

Because the case study provides limited information about various financial aspects of Newsreader, several of the cost of capital methods may not be used. One method that the consultant may use to value Newsreader is the beta of comparable companies' method. A company's beta is a reflection of its debt levels and firms with high levels of capital and low levels of debt have higher betas than firms with high levels of debt (Dammar, n.

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D; University of Maryland, n. D. ).

This nod would be accomplished by first determining the company's beta and then comparing it to the industry average, which is 1.07 for levered and 1.

05 for unlevered. This method may also be accomplished by comparing Newsreader's beta to select companies that are similar in size to benchmark its performance. For example, if Newsreader is a public company, its beta can be obtained from a reputable finance source/website, its beta levered beta is 0.97, and the unlevered beta is 0.98, it is performing within industry standards when compared to its competitors and the average company beta.

Another valuation method, the cost of equity, is used by investors and analysts to determine the annual expected return on the investment in company stock (Valuable.

Net, n. D. ). This method requires knowledge about the market rate of return for risk-free securities; the market rate of return for similar securities; and the risk level or beta associated with a company's stock. As indicated in the case study, the risk-free rate was 4.84 percent, the market rate of return was 7.

1 percent; however, sufficient information was not provided to determine the company's beta. D) Valuation Using Discounted Cash Flow:

D) Valuation Using Discounted Cash Flow: According to Chapter 2 of our textbook (Forecasting and valuing cash flows) "The idea behind discounted cash flow (DC) valuation analysis is simple: The value of an investment is <https://assignbuster.com/newgrade-case-study/>

determined by the magnitude and the timing of the cash flows it is expected to generate. The DC valuation approach provides a basis for assessing the 'value' of these cash flows, and consequently it is a cornerstone of financial analysis". Valuation: the art and science of corporate investment decisions; P. 20).

With the method of keeping the valuation of using discounted cash flows in perspective,

Newsreader Energy in exhibit 5, key analysis was placed on forecasting crude oil and natural gas prices and production based on actual historical averages (Exhibit 4), operating expenses estimated by management and capital expenditures. Protected by the "clean air" regulation, capital expenditures were forecasted to escalate as a result of the aging facility. Cash taxes from 2008 to 2025 also included a capital cost allowance tax shield to 2004, which basically allows Newsreader a reduction in the amount of income subject to tax that results from the presence of capital cost allowance on their income statement.

From Exhibit 4 it is very clear that Newsreader is profitable company with available cash flow. Forecasts from 2011 to 2014 show Newsreader cash flows declining, However cash flows begin to increase every year from 2015 to 2025 (The period from 2011-2014, may have been a five year plan to reinvest in company). Figure I-A below gives a visual explanation of how the valuation using the discounted cash flow.



E) Describe the Valuation using Comparable Method: Several types of comparable methods are used to value businesses. One common method, comparing competitors' betas, was discussed in the previous section.

However, a consultant may also compare other data such as trading data to provide assistance with conducting company evaluations. Exhibit 8 of the case study provides the most commonly used trading data used for valuation purposes, which includes stock prices, market cap, and price-to-cash flow. For example, if New Grade's 2007 price-to-cash flow was 6.

2, it would be performing close to the industry average, which is 6.7 percent or above the industry average when compared to the average Nike excluding the two highest performing companies ratios, which is an industry average of 5.8 (Hatch & Khan, 2011).

F) Describe the Valuation using Precedent transactions Method: Precedent transaction methods are used to value businesses based on prices paid for a company's stock in comparison to similar companies. This method is useful for assisting analysts when multiple premiums are paid for similar companies and provide guidance on the determination of values for private market valuations (Mossbacks, 2013).

The information provided in Exhibit 7 of the case study is similar to the type of information required to determine the reasonableness of a price offering for New Grade using precedent transactions.

Exhibit 8's information is an essential part of the valuation because New Grade's pricing determination would be based on its key assets, transaction

value, and total enterprise value. Although the precedent transactions method is resourceful, it has several disadvantages. The most notable disadvantages are the possibility of obtaining limited and misleading public data; influences of market conditions on valuations; limited transaction aspects; limited usefulness of the information collected due to wide value ranges; and unique circumstances that limit the comparability of companies (Mossbacks, 2013).

G) As the adviser to Stunt, assess the value of Chic's equity interest in Newsreader by employing the free cash flow method with no debt, free cash flow method with 25% debts, the comparable method and the precedent transactions method: Crown Investment Corporation's (ICC) equity interest in New Grade will be determined by employing the free cash flow method with no debt and 25 percent debt; and using the comparable and precedent transactions methods. As previously discussed, the free cash flow method is calculated by subtracting the change in net working capital and capital expenditures from the firm's BIT.

The most current data for New Grade is for the 2007. The 2007 data provided in the case study indicates that the BIT is \$198.35 million, capital expenditures are \$5.5 million, and it is assumed that the company did not have a change in net working capital based on the case study revelation that the company has no debts. Considering this information, the free cash flow with zero debt is \$192.85 million, which results in \$96.

425 million in free cash flow for ICC because of its 50 percent interest. If New Grade had 25 percent debt, it would have \$112.5 million debt if the debt is

current [ $\$15[\$150 \text{ million} - (\$150 \text{ million ash asset} \times 0.25)]$ ] a result, the free cash flow with 25 percent debt would be \$80.

35 million, which results in \$40.175 million in free cash flow for ICC because of its 50 percent interest. Chic's value cannot be determined using the comparable method because viable information, such as the company's share price, is not provided. However, the precedent transactions method may be used if it is assumed that the enterprise value is equal to the \$150 million cash balance and the \$770 million capital cost or \$920 million total enterprise value (TV).

If the TV of \$920 million is divided by the EBITDA of, \$198.

5 million results in a TV/EBITDA of 4.6 times (Hatch Khan, 2011). The average TV/EBITDA of the companies selected for the precedent method is 4.5 times; therefore, the TV/EBITDA should provide a reasonable basis for ' alumni New Grade. H) What is the average valuation of Newsreader? The process at which to evaluate the estimate value of Newsreader Energy (ENG) is determined by valuation used by financial markets.

The initial step would be to analyze the company's assets, past performance and current market trends.