Congoleum corporation question essay sample

Finance, Investment

In this case, you have to evaluate the LBO proposal and decide whether the $38 per share o¤er price is appropriate. You will combine the valuation principles and methods discussed in the course to evaluate a complex transaction from the perspectives of the various participants. Your write-up should address and defend the assumptions that underlie the inputs to your analysis before you proceed to present your results. The following questions should be addressed in your report, and will serve to organize your discussion:

1. What characteristics of Congoleum make it a likely candidate for a leveraged buyout? 2. How would you go about estimating the borrowing cost in the LBO years and the borrowing cost in the post-1984 period? In particular, it would probably not be legitimate to use the coupon rates on the new LBO debts as rD in the LBO years. Why? For the post-1984 period, should we expect the bond rating to improve (and rD to decrease)? Why or why not? 3. Based on your analysis, what do you think of the $38 per share o¤er? Your valuation analysis should make up the bulk of your report and serve to answer this question. More speci…cally: Which is the best valuation approach to deal with the changing debt ratios in 1980-1984? Which valuation method would you use to value the post-1984 cash ‡ ows?

How would you estimate Congoleum' long-term (post-1984) debt ratio? Based on your understanding of the case facts, what growth rate would you use? How sensitive is your result to the choice of growth rate?

4. Why would institutional investors be willing to …nance a leveraged buyout with the capital structure proposed? What are the roles of the " equity kicker" and " strip …nancing" ? 5. Where will the value for the acquisition

premium of 50% come from in the proposed buyout? What portions of the purchase premium are attributable to: 1) the cost savings in corporate expenses for 1980-1984, as mentioned in Exhibit 14? 2) the step-up of asset values for depreciation for 1980-1984, as mentioned in footnote b in Exhibit 13? the interest tax shields, as mentioned in footnote a in Exhibit 13? Where does the rest of the value come from? 6. What is the size of the potential reward for the management of Congoleum in the leveraged buyout?

To make your analysis a bit easier, let us agree on the following general assumptions.

It is convenient, for valuation purposes, to assume that all debts (old, new, preferred stock) are paid o¤ at the end of 1984 when the LBO group takes the company public again and sells it for its terminal value. (If these debts are not paid o¤, then the new buyer of the company will pay a price equal to the terminal value minus the value of outstanding debts.) Feel free to use the information in the footnote to Exhibit 9 as your inputs (riskfree rate and market premium) to the CAPM.

Feel free to do all your levering/unlevering assuming a debt beta of zero. Wherever the case mentions “ Debt % capital” you can treat that as the correct D= V . Usually, we prefer market equity when available.
Preferred stock can be thought of as a type of debt that does not create interest tax shields. Your …nal valuation of Congoleum needs to adjust for excess cash and unfunded pension liabilities, as listed in Exhibit 7.

Keep in mind that there is no “ right” answer in this case. But your analysis must be internally consistent. To support your recommendation, you might also want to consider doing sensitivity analysis on your assumptions.