

Case study example



Case Study Brooks and the rest of the Harrington management team should consider pursuing a buyout of the Company for the following reasons: (a) The Company is the leader in a small, lucrative market segment

(b) The Company has been turning in profits every year since 1932, which has surged even further since 1970 with very healthy rate of returns

(c) Provides Brooks and the team an opportunity for career continuity

(d) Purchase price is relatively reasonable for the value of the Company due to its profitability#

(e) Small range of products with an already established base of loyal customers.

2. As may be noted from Exhibit 7, the amount available for debt retirement in 1971 is \$724, 000. The covenant of 1971 sets out the following which are not to be breached, i. e. , working capital not to decline below \$1, 500, 000 in any given year and a substantial portion of the assets of the borrower are not to be sold. The amount already used for capital expenditure is 60, 000 and the increase in working capital is 78, 000, thereby bringing the amount to a total of 138, 000, which leaves an amount of \$1, 362 thousand dollars. Since working capital should not decline below £1, 500 thousand dollars, Brooks has only this amount available to invest and cannot opt for either £1750 or \$2250 thousand dollars. Hence the only available option is \$1250 thousand dollars.

3. The five sources of financing are:

(a) cash and marketable securities - \$2. 88 million

(b) Accounts receivable - \$1. 27 million

(c) Property, plant and equipment - \$ 1. 06 million

(d) retained profits: 4. 85 million

(e) Common stock: 0.1 million

TOTAL: \$10.16 million

4. The free cash flow to capital from 1971 to 1976 is given by the sum of the amounts available for debt retirement., which totals to an amount of 5584 thousand dollars.

5. The formula to calculate terminal value using the perpetuity method is given as: $FCF_n \times (1+g) / WACC - g$, where FCF_n is the FCF for the last 12 months of the projection period, g is the perpetuity growth rate and WACC is the weighted average cost of capital. Using this formula,

$TV = 1001,000 (1+0) / 10\% - 0\% = 1001,000 / 10\% = \$10,010,000$ or roughly \$10 million.

6. Total interest expense from 1971 to 1976, based upon Exhibit 7 equals 3049 thousand. The actual Interest tax shield (interest expense X tax rate) in a given year equals the minimum of the calculated ITS and the projected taxes before the ITS is applied. ITS for each year is thus given as follows:

ITS 1971 = $637,000 \times 15.6\% = \$99,372$

ITS 1972 = $585,000 \times 17.3\% = \$101,205$

ITS 1973 = $523,000 \times 18.4\% = \$96,232$

ITS 1974 = $454,000 \times 20.5\% = \$93,070$

ITS 1975 = $400,000 \times 22.1\% = \$88,400$

ITS 1976 = $400,000 \times 22.5\% = \$90,000$

Total ITS for the entire period: \$568,279.

7. The Adjusted Present Value method may be calculated as the sum of the FCFs discounted by the cost of the assets plus the interest tax shields which are discounted at the cost of debt. The present enterprise value of the corporation for 1971:

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The free cash flow available in 1971 is \$726 thousand. The terminal value is \$10, 010. Therefore, the sum of PCF and TV is 10726. The interest tax shield available in 1971 is \$99372; hence the present adjusted value of the enterprise is \$10825372 or about \$10 million.

8. Since the investors are prepared to provide \$4750 thousand at the rate of 9%, the interest payable amounts to \$2, 137, 500. In order to ensure that the investors are motivated to offer the large amount of capital, the company needs to make sure that they are allowed purchase at least 6 million shares as warrants.