UNIVERSITY OF COLOMBO

FACULTY OF MANAGEMENT AND FINANCE

Postgraduate & Mid-career Development Unit

Master of Business Administration in Finance (Semester IV First-half) (2014 - 2016)
Examination- November - 2016

MBAFI 617- Business Analysis and Valuation

- **Three (03) Hours**
- **Answerer Four (04) questions in all including question number 01.**

01.

KJH Holdings PLC (KJH) is a very successful conglomerate which has consistently followed a business strategy of aggressive acquisitions. The Board of directors of KJH is looking for companies with potential but which were poorly managed and having a below market value as part of their growth strategy.

KJH has maintained its price earnings (P/E) ratio on the stock market at 12.5 and KJH's 2016 figures show a profit after tax of Rs. 900 million and it has 380 million shares in issue.

DISPvt is a well-established owner-managed business. In financial terms it has a rather mixed history with its up and downs corresponding directly with the state of the global economy.

Financial performance of the Company for the year 2016 is as follows:

	Rs.mn
Revenue	1,600
Operating profit	480
Interest cost	(130)
Profit before tax	350
Taxation @ 25%	(87.5)
Profit after tax	262.5
Number of shares in issue	150m
EPS	Rs. 1.75

DIS's management team feels that revenue will increase by 10% per annum up to and including 2020 due to the expectation of improvements in global economy. The company's operating profit margin is not expected to change for the foreseeable future.

Operating profits are shown after deducting non-cash expenses (including tax allowable depreciation) of Rs.125m. This is expected to increase in line with sales. However, the company has recently spent Rs.200m on purchase of non-current assets. DIS's management believes this value will have to increase by 10% per annum until 2017 to enable the company to remain competitive. DIS has estimated its overall cost of capital to be approximately 12%, but this assumes it will maintain its debt to equity ratio at 38:62.

Some of DIS's major shareholders are not so confident about the future and would like to sell the business as a going concern. The minimum price they would consider would be the fair value of the shares, plus an 8% premium. DIS's CFO believes the best way to find the fair value of the shares is to discount the forecasted free cash flows of the firm, assuming that beyond 2020 these will grow at a rate of 3% per annum indefinitely.

You are Required

(i) As at 1 January 2017, prepare a schedule of DIS's forecast free cash flows for the firm. Ascertain the fair value of the DIS's equity on a per share basis.

(15 marks)

(ii) KJH intends to make an offer to DIS based upon a share for share swap. KJH will exchange one of its shares for every two DIS shares. Assuming that KJH can maintain its Price/Earnings (P/E) at 12.5, calculate the percentage gain in equity value that will earned by both groups of shareholders?

(20 marks)

(iii) What factors should the DIS shareholders consider before deciding whether to accept or reject the offer made by KJH?

(5 marks)

(Total Marks 40)

02.

(i) Explain the going concern assumption and contrast a going concern value to a liquidation value.

(5 marks)

(ii) Compare the free cash flow to the firm (FCFF) and free cash flow to equity (FCFE) approaches to valuation.

(07 marks)

(iii) What are the main arguments for using either free cash flow to equity and dividends in equity valuations?

(08 marks)

(Total Marks 20)

03.

(i) Describe definitions of value, and which definition of value is most relevant to public company valuation.

(5 marks)

(ii) Distinguish between the method of comparables and the method based on forecasted fundamentals as approaches to using price multiples in valuation, and explain economic rationales for each approach.

(10 marks)

(iii) MK Technologies shares are selling for Rs. 50.Earnings for the last12 months were Rs.2per share. Theaveragetrailing P/Eratiofor firmsin MK'sindustryis32times. Determine whether MKI sover-or undervalued using the method of comparables.

(5 marks)
(Total Marks 20)

04.

(i) Explain the importance of strategy analysis in business valuation

(7 marks)

(ii) Accounting analysis is an important activity of business valuation process which helps to detect and undo accounting distortion. Explain common red flag areas in financial statements.

(8 marks)

(iii)X Ltd is intending to acquire B Ltd. (by merger) and the information available in respect of companies.

	A Ltd	B Ltd
No of shares	5,000,000	3,000,000
Earnings After Tax	20,000,000	6,000,000
Market value per share	18	12

(a) If the proposed merger takes place, what would be the earnings per share for x Ltd? (Assuming that the merger takes place by exchange of equity shares & exchange ratio is based on the current market prices).

(b) What should be the exchange ratio, if B Ltd wants to ensure same earnings to the members as before the merger takes place?

(5 marks)

(Total Marks 20)

05.

(i) Discuss the advantages and disadvantages of using price-to-book (P/B) ratio in business valuation

(7 marks)

(ii) Based on the information in the following table, calculate the current P/B ratio for CriscoPLC and Lemon PLC.

Company	Book Value of Equity 2016 Rs. Millions	Sales 2016 Rs. Millions	Shares outstanding 2016 Millions	Share price 2016 Rs.
Crisco PLC	28,039	18,878	7001	17.83
Lemon PLC.	6,320	9,475	5,233	12.15

(5 marks)

(iii) What are the alternative ways of estimating growth in earnings?

(8 marks)

(Total Marks 20)

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