CPA IRELAND SKILLNET

CPA Ireland Skillnet

CPA Ireland Skillnet, is a training network that is funded by Skillnets, a state funded, enterprise led support body dedicated to the promotion and facilitation of training and up-skilling as key elements in sustaining Ireland's national competitiveness.
The CPA Ireland Skillnet provides excellent value CPE (continual Professional Education) in accountancy, law, tax and strategic personal development to accountants working both in practice and in industry. However our attendees are not limited to the accountancy field as we welcome all interested parties to our events.

An Roinn Oideachais agus Scileanna | Department of Education and Skills

Skillnets Enterprise-led learning networks

The CPA Ireland Skillnet is funded by member companies and the Training Networks Programme, an initiative of Skillnets Ltd. funded from the Department of Education and Skills.

www.skillnets.ie

CPA IRELAND SKILLNET

Trainee Accountant Workshop Series

July 2016

Current Issues in Strategic Corporate Finance

Solutions to June 2015 Exam

CPA IRELAND SKILLNET

SCF Examination August 2015

Azorian

3

CPA SKILLNET

Case Study - Azorian

Azorian plc is listed on the Enterprise Securities Market (ESM) in Ireland. It owns a chain of hotels which are spread throughout the length and breadth of the Republic of Ireland. It has come through the recent recession relatively unscathed, this is due in part to the fact that its hotels are by and large well located. The majority of Azorian's hotels are located in Dublin. Furthermore it did not purchase any new hotels since 1997. Therefore, it did not overpay for any of its hotels in the boom and also has relatively low borrowings. Nonetheless its profitability was severely affected by the recession with turnover being reduced significantly over the period 2008-2011.

4

CPA SKILLNET

Case Study - Azorian

Azorian's shares have traded on the ESM for a number of years and its ownership structure is such that only three institutional shareholders own more than 1% of the firm. About 80% of the shares of Azorian are held by institutional investors such as insurance companies, pension funds and hedge funds. There are 50 million shares in issue. They currently trade at €5 each. The current Azorian management team own about 10,000 shares. Azorian's CEO, Bill Hoskins, owns the vast majority of the management's shareholding and he owns 8,000 shares. He does not hold shares in any other company but he contributes to Azorian's staff pension fund.

5

CPA SKILLNET

Question 1

(a) Value the brewery division of Glytherdale based on the projections outlined in Table 2 and the information gleaned by Fred Falstaff. Advise the board as to what to do based on your valuation.
(30 Marks)

(b) Explain why you do or did not make an adjustment for corporation tax when computing the cost of capital for the breweries project. Did it matter whether you did or did not?
(15 Marks)

(c) Robert Cramer explains the difference between what he perceives as the market value for Glytherdale's breweries and their book value in terms of their growth prospects. Explain how the market-to-book ratio of a business is related to its expected growth rate.
(5 Marks)
(Total for question 1 = 50 Marks)

6

CPA IRELAND SKILLNET

Question 2

(a) Briefly outline the main principles of diversification i.e. how diversification can reduce risk without sacrificing return.
(5 Marks)
(b) Bill Hoskins seems well aware of the principles of diversification. How diversified does Bill appear to be on a personal level? Advise him on how he might further diversify his holdings of financial assets outlining the most efficient methods of achieving risk reduction.
(10 Marks)
(c) Critically evaluate whether the diversification provided by purchasing a business in a different industry is a good reason for Azorian to acquire the breweries?
(10 Marks)

7

CPA IRELAND SKILLNET

Question 3

(a) Comment on the merits or otherwise of the board of Directors of Azorian as a pivotal corporate governance mechanism on the basis of the information outlined in the case.

(13 Marks)

(b) Detail the additional information that would you like to know in order to make of full assessment of the *overall* standard of Corporate Governance in Azorian.

(12 Marks)

(Total for question 3 = 25 Marks)

8

CPA IRELAND SKILLNET

Question 4

(a) Critically evaluate Bill's argument that the purchase of hotels in the UK increases risk and thus in an inferior alternative to the purchase of breweries in Ireland. (10 Marks)

(b) In terms of Mergers and Acquisitions how would you classify the brewery project from the perspective of Azorian and from the perspective of Glytherdale. (5 marks)

(c) A supplementary reason for the takeover of the four breweries by Azorian as espoused by Bill is the prospects for growth it provides. Critically evaluate the achievement of "growth" as an objective of a business in general and Azorian in particular.
(10 Marks)

9

CPA IRELAND SKILLNET

The five largest shareholders are outlined in Table 1

Table 1 Largest Shareholders of Azorian	
Investor's Name	Number of Shares Owned
Fickle Hedge Fund	1,585,000
Safety First Pension Fund	960,000
Diversified International Mutual	545,000
Responsible & Sustainable Fund	130,000
Well Diversified Irish Widowers	12,000

10

CPA IRELAND SKILLNET

While business has improved since 2011 Bill Hoskins feels that the hotel industry is rather cyclical and believes that Azorian should diversify into at least one other business in order to reduce its risk. He argues that no company should put all its eggs in one basket. His current mantra seems to be "diversification can reduce risk without sacrificing return: all businesses should diversify, it's just common sense"

11

CPA IRELAND SKILLNET

Bill has also noticed the emergence of craft breweries. Azorian is buying more and more beer, ale and stout from such small local breweries. It is finding that its customers both local and tourists alike are turning to craft beer instead of the produce of the large drinks producers like Diageo and Heineken. He reckons that with additional restrictions on the advertising of alcoholic beverages that the large companies will find it impossible to continue their dominance of the industry. Thus there will be even more opportunities for artisan breweries in the future. He sees the purchase of a few artisan breweries as a method of expanding Azorian and simultaneously reducing risk. More profits and less risk he thinks: what could be wrong with that?

12

CPA IRELAND SKILLNET

Glytherdale plc is another Irish company which amongst other things controls four craft breweries: St. Finbarr's in Cork, St. Philbert's in Waterford; St. Ulick's in Dublin; DT's in Limerick. The last named derives its name from its famous blond beer The Devil's Tipple. St. Finbarr's is best known for Hairy Harry's, a strong stout with 7% alcohol, which is very popular with Corkonians. St. Philbert's mainly brews a number of smooth ales of which "The Stoat" is its bestselling brand. St Ulick's main product is the eponymous Belgian Blond beer.

13

CPA IRELAND SKILLNET

Glytherdale's breweries were all rather small in terms of turnover when purchased by Glytherdale. They have developed the markets for their products to the extent that they can no longer keep up with demand and need to urgently expand their production facilities. Glytherdale's primary interests, however, lie elsewhere. The person who managed the brewery section of Glytherdale's business has since left the company. Robert Cramer, Glytherdale's CEO, is not keen to recruit another specialist in the brewing industry. All the craft breweries have to be run as essentially independent companies since it is vital that they do not lose their artisan status.

14

CPA IRELAND SKILLNET

This is proving a bit of a problem for Robert and he is of the opinion that he does not have the same level of control over the breweries as he has over the remainder of Glytherdale's business. The breweries need some investment since there are significant economies of scale in the brewing industry and they need to upscale to exploit their expanding market. The need to run the four breweries as independent businesses in order to maintain their craft status as mentioned above is also problematic. Glytherdale's main business involves running a chain of retail outlets. It has made the decision to focus on its main business and is actively seeking a buyer for its breweries.

15

CPA IRELAND SKILLNET

Bill Hoskins meets Robert Cramer the CEO of Glytherdale to discuss the sale of the four breweries to Azorian. Robert provides Bill with the 2015 final statements and projected accounts for Glytherdale's Brewery Division from 2016 to 2019. These are outlined in Table 2. Robert explains that he reckons that the craft beer sector will grow by 5%- 6% over the next couple of years. However, the growth rate will settle down to a long run growth rate of 1% from 2018. These growth rates are reflected in the projections outlined in Table 2.

16

CPA IRELAND SKILLNET

Robert Cramer goes on to state that the Board of Glytherdale reckons that the assets of its brewery division are worth about €600 million (though their book value is only €130 million). With debts of €40 million he reckons that Glytherdale would accept an offer in the region of €560 million for the division. Robert explains this rather high Market-to-Book ratio for the breweries stems from their growth prospects. A few days after the meeting with Cramer, Bill Hoskins reports back to his board. He requires the approval of the board before any offer can be made to purchase the brewery division of Glytherdale. Details of Azorian's board are outlined in Table 3.

17

CPA IRELAND SKILLNET

Table 3 - Board of Directors Azorian	
Bill Hoskins	CEO for the past 15 years; has worked in the hotel industry since he was 18. He is now 49 years old
Bertram McKenzie (British)	Chairman, Former banker and board member of Visit Scotland; 60 years of age.
George Gilhooley (Northern Ireland)	NED, Chief operating officer of a large Belfast hotel; 50 years old.
Brian Pitt, BComm, CPA	NED, Partner in Pitt & Co. Certified Public Accountants; 48 years old.
David D'Arcy	NED, Michelin Star Chef and owner of a famous Dublin Restaurant; 38 years old.
Terence Michael	NED, Founder of Michael Travel which he recently sold to a British plc; 52 years old.
Humphrey Bolger, BE, MBA,	NED, Founder and former CEO of Bolger Engineering; now NED on another Irish plc quoted on the main market as well as of Azorian; 55 years old.

18

CPA IRELAND SKILLNET

The board has three committees. The audit committee is comprised of Messrs. Pitt (Chair) and Bolger; the nomination committee comprises Messrs. Michael (Chair), McKenzie and Gilhooley; the remuneration committee is comprised of Humphrey Bolger (Chair) and Terence Michael.

CPA IRELAND SKILLNET

The board of Azorian listens to Bill as he outlines the merits of the takeover. Bill waxes lyrical about an exciting new era for Azorian and the tremendous growth prospects in the craft beer industry. Another factor that he stresses is that the beer production will make Azorian more diversified and reduce its risk. "If we stick with hotels we will not achieve the growth required by shareholders", Bill declares. He goes on to explain that there are so many hotels in Ireland at the moment that there is no room for expansion here. He points out that expanding to say, the UK, would entail additional risks including foreign exchange risk. He stands up and declares to the board "the purchase of the breweries not only delivers much needed growth but actually reduces risk as well". The board listens carefully to Bill and it decides to call in Azorian's auditor, Fred Falstaff, CPA to value the breweries to see if they are worth the €560 million asking price.

CPA IRELAND SKILLNET Q1 (a)

Income Statements to 30th June in €000s

	2015A	2016	2017	2018	2019
Sales	200000	212000	222600	229278	231571
Operating Expenses	180000	190800	191436	201765	203782
Operating Income	20000	21200	31164	27513	27788
Interest	1800	2000	3400	3300	3300
Profit Before Tax	18200	19200	27764	24213	24488
Taxation	2275	2400	3471	3027	3061
Net Profit After Tax	15925	16800	24294	21187	21427
Dividends	10000	10000	10000	12000	12000
Addition to Equity	5925	6800	14294	9187	9427

Balance Sheet as at 30th June in €000s

	2015A	2016	2017	2018	2019
Fixed Assets	90000	120000	133560	137567	138942
Net Current Assets	40000	42400	44520	48148	48630
Operating Assets	130000	162400	178080	185715	187572
Cash	0	2400	-987	565	2135
Net Assets	130000	164800	177094	186280	189708
Shareholder's Equity	90000	96800	111094	120280	129708
Debt	40000	68000	66000	66000	60000
Total Financing	130000	164800	177094	186280	189708

Fred Falstaff, establishes that the accounts and projections for the breweries are reasonable. He further confirms that the brewing industry is of average systematic risk so the equity beta of a brewery can be approximated by the average beta of all stocks. The market risk premium [$E(R_m) - R_F$] is 4.5% and the risk free rate of interest is 0.6%. Azorian's beta is 1.1.

Calculation of the cost of Capital for Breweries			
Here debt adjusted for corp. tax		Here debt is not adjusted for Corporate Tax	
Rf	0.6	Rf	0.6
Beta	1	Beta	1
Rm-Rf	4.5	Rm-Rf	4.5
Cost of Equity	5.1	Cost of Equity	5.1
Cost of Debt*(1-T)	3.5	Cost of Debt	4
Market Value of Equity	560	Market Value of Equity	560
Value of Debt	40	Value of Debt	40
Value of Breweries	600	Value of Breweries	600
E/V	0.933	E/V	0.933
D/V	0.067	D/V	0.067
WACC	4.993	WACC	5.027
E/V*Ke	4.760	E/V*Ke	4.760
E/V*Kd(1-T)	0.233	E/V*Kd	0.267
WACC	4.993	WACC	5.027

Financial Statements

Computation of Free Cash Flow	2016	2017	2018	2019
Operating Income After Tax	18800	27694	24487	24727
ΔNOA	32400	15680	7635	1857
Free Cash Flow (OI - ΔNOA)	-13600	12014	16852	22870

CPA SKILLNET

		2016	2017	2018	2019
FCF		-13600	12014	16852	22870
Discount Factor		1.050	1.103	1.158	1.216
DFCF		$\boxed{-12952}$	$\boxed{10897}$	$\boxed{14557}$	$\boxed{18815}$
Terminal Value					577475
PVDFCF to 2019	31317				
PVTV	475090				
Enterprise Value	506406				
Less Value of Debt	40000				
Value of Equity	466406				

$\frac{FCF_{2020}}{r-g}$

$\frac{22870 * 1.01}{.05-.01}$

$\frac{57475}{1.216}$

CPA SKILLNET

Answer to 1 (a)

Clearly Glytherdale's Brewery division is worth approximately €466 million which is substantially less than what is being sought by Glytherdale.

There are also other negative aspects to takeover

Lack of experience of Azorian in the Brewing industry

The motivation for the purchase

CPA SKILLNET

Answer to 1 (b)

No adjustment for corporation tax could be justified as follows

- The corporation tax rate in Ireland is so low it will not provide a large tax shield
- It is difficult to justify adjusting for one market imperfection (Corporate Tax rates) and not making allowances for other such as non-debt tax shields, personal tax rates, bankruptcy costs, agency issues etc.
- There may be some capital allowances for the CAPEX projected to be undertaken in 2016; 2017 which will reduce the need for the tax shield provided by debt.
- If the gearing ratio was greater this would still not make much of a difference – if it were very high one would really have to consider bankruptcy costs. Taking a high debt to equity ratio of 100% (D/V = 0.5) we would get a WACC of 4.3% with the CT adjustment and 4.55 without it.

CPA SKILLNET

1 (b) Argument for Tax Adjustment

- The gearing is low so bankruptcy and other costs of debt are unlikely to be factors.
- It is clear from the projections that the company is expected to be profitable and will ultimately have to pay tax regardless of capital allowances.
- It is standard practice to make this adjustment.

28

CPA SKILLNET

Q1 (c) How is growth related to Market-to-Book ratio

Look at RIVM – Explanation of RIVM
Market Value of a Business (M) = Book Value (B) + Present Value of Expected Residual Income:
M = B + PVRI
Residual Income: $RI_t = E_t - rB_{t-1}$
$\frac{M}{B} = 1 + \frac{PVRI}{B}$
The more earnings are expected to grow then the greater is PVRI and the MTB ratio other things being equal.

29

CPA SKILLNET

Growth continued

- For a MTB of 1 PVRI = 0 and price (market value) equals book value.
- For an MTB > 1 PVRI is positive – the market expects high earnings (positive RI) in the future and this is reflected in the value of the stock.
- For an MTB < 1 PVRI is negative – the market expects low earnings (negative RI) in the future.

30

CPA IRELAND SKILLNET

Answer to 2 (a)

The crucial inputs into the calculation of the variance or risk of a portfolio are the correlation coefficients between the securities that comprise the portfolio and the number of securities in the portfolio.

Lower the correlation coefficients and a greater number of shares in the portfolio will reduce its risk.

31

CPA IRELAND SKILLNET

Answer to 2 (b)

Bill has a one security portfolio, Azorian. To make matters worse he has all of his human capital tied up in Azorian. However, it should be noted that he is contributing to a pension fund. This is likely to be well-diversified so depending on the level of his pension fund and how diversified it is he may not be too badly off at all with respect to diversification. We would really need to know if the Azorian pension fund had invested in any hotels or the tourist industry.

32

CPA IRELAND SKILLNET

Bill needs to consider

1. the number of shares in his portfolio
2. the correlations between the returns on the shares in the portfolio

- A more efficient method for Bill to achieve more diversification would be to invest in a mutual fund or an exchange traded fund (ETF) rather than purchase shares directly himself. The mutual fund or ETF purchase gives him a full portfolio for a modest cost. The ETF would have the lowest costs. However, the purchase of shares directly would allow Bill to fine tune his risk better.

33

CPA SKILLNET

Answer to 2 (c)

1. Firms usually have to pay a premium for control. So it will be more expensive for a firm to purchase another firm than for the shareholders of the purchasing firm to buy some shares in the target firm.

2. The shareholders of Azorian are generally institutions who will be well-diversified. They don't need Azorian to do something for them that they could do more cheaply themselves.

3. A minor supplemental point is that Azorian has no expertise in the Brewing industry so it is difficult to see how they can add any value with the takeover of the breweries.

34

CPA SKILLNET

Answer to Q3 (a)

- Azorian's board is well structured in the following respects
- It has a majority of independent NEDs
- There is CEO/Chair Duality
- It has a good diversity of professions
- It has good industry experience
- Its committee structure appears sound
  - three crucial committees
  - audit committee is independent and has financial expertise.
  - the other committees are independent or the majority independent.
- The board is not too large or too small. Large enough for a diversity skills small enough for good communication.
- However it is noted that the board has no female member. It does not reflect diversity with respect to gender.

35

CPA SKILLNET

Answer to 3 (b)

With respect to the board I would like to have information on the following:

- The number of times it and the committees met.
- The attendance of each of the board members.
- The length of time each of the members has been on the board (after a period of time their independence wanes).
- Details of their remuneration and how they are remunerated.
- Detail of their contracts.
- Who is the senior independent director?
- Any business dealings the NEDs have with Azorian.

36

CPA SKILLNET

Other aspects of governance that we need to know about

- The remuneration of Bill Hoskins: structure and amount
- The market for corporate control in the Hotel Industry in Ireland
- What is the market like for managers of hotels (the managerial labour market)?
- We know that the management do not have many shares in Azorian so there is a clear separation of ownership from control.
- We also know that by and large the shareholders each have a relatively small stake in Azorian so there may be a free rider problem when it comes to monitoring: the board should help here.
- We know that the leverage is low so that there will not be much if any monitoring by the banks.

37

CPA SKILLNET

Answer to 4 (a)

- Bill is referring to the exchange risk here which would be occasioned by having hotel assets denominated in sterling.
- However, to the extent that the tourist industry in Ireland and hence at least some of Azorian's customers are already based on non-Euro areas Azorian is already subject to FX risk. In fact it could be argued that having some sterling denominated assets may give some diversification of currency.
- What would change is the nature of the FX risk. At the moment Azorian is subject to long-term operating FX risk. This refers to the price competitiveness of its product. So if sterling becomes weak relative to the Euro UK – based people find it more expensive to holiday in Ireland: US citizens will find that the UK becomes a more price competitive destination for their European holiday.

38

CPA SKILLNET

Answer to 4 (a)

- Having a chain of UK hotels would be different in that there would be translation exposure for the balance sheet. But the ex-ante version of translation exposure would also be new – Azorian would have assets whose Euro value could vary with the exchange rate with sterling.

39

CPA SKILLNET

Answer to 4 (b)

- From the perspective of Azorian the brewery project is conglomerate diversification
- From Glytherdale's perspective it is a spin-off.

CPA SKILLNET

Answer to 4 (c)

Growth in profits, cash flows, dividends and asset values is good. The reason that such growth is good is that it is an indication of value. The fundamental objective of the firm is to maximise shareholder value and it achieves this by maximising its own value.

But growth is not the objective – it is just one method of achieving it.

CPA SKILLNET

Be careful about paying too much for growth!

When you are acquiring a company sometimes as in the Azorian case you will pay for growth and you have to be careful that you do not pay too much. It is clear from the projections that the breweries are growing though the rate tampers off to a mere 1% after two years. Acquiring the breweries will certainly deliver growth for Azorian but it is a poor investment. Growth is not the primary objective of a business: maximising shareholder value is. Growth is just an *indication* of value creation. It is clear from the valuation of the breweries that they are overpriced at €560 million: this is the first reason that they are a poor investment. Azorian would by paying too much for the growth it acquired. The people who would exclusively gain from the increase in value that is derived from the growth in the breweries are the shareholders of Glytherdale.

CPA SKILLNET

Finally

- The second reason that the breweries are a poor investment is that diversification is something that Azorian's shareholders can do more cheaply and easily themselves. Thus the takeover would destroy shareholder wealth.

43

CPA SKILLNET

Full solution with tutorial elements is available at

Solution

44