Introduction

Westparley Co is a listed retailer, mainly selling food and small household goods. It has outperformed its competitors over the last few years as a result of providing high quality products at reasonable prices, and also having a stronger presence online. It has kept a control on costs, partly by avoiding operating large stores on expensive city centre sites.

Instead, it has had smaller stores on the edge of cities and towns, and a limited number of larger stores on convenient out-of-town sites, aiming at customers who want their journeys to shops to be quick. One of its advertising slogans has been: ‘We are where you want us to be.’

Westparley Co’s share price has recently performed better than most companies in the retail sector generally. Share prices in the retail sector have been relatively low as a result of poor results due to high competition, large fixed cost base and high interest rates. The exception has been shares in retailers specialising in computer and high-technology goods. These shares appear to have benefited from a boom generally in share prices of high-technology companies.

Some analysts believe share prices of many companies in the high-technology sector are significantly higher than a rational analysis of their future prospects would indicate.

Matravers Co

Westparley Co has identified the listed retailer Matravers Co as an acquisition target, because it believes that Matravers Co’s shares are currently undervalued and part of Matravers Co’s operations would be a good strategic fit for Westparley Co.

Matravers Co operates two types of store:

Matravers Home mainly sells larger household items and home furnishings. These types of retailer have performed particularly badly recently and one major competitor of Matravers Home has just gone out of business. Matravers Home operates a number of city centre sites but has a much higher proportion of out-of-town sites than its competitors.

Matravers Tech sells computers and mobile phones in much smaller outlets than those of Matravers Home.

Extracts from Matravers Co’s latest annual report are given below:

	$m
Pre-tax profit	1,950
Long-term loan	6,500
Share capital ($1 shares)	5,000

The share of pre-tax profit between Matravers Home and Matravers Tech was 80:20.

The current market value of Matravers Co’s shares is $12,500m and its debt is currently trading at its book value. Westparley Co believes that it will have to pay a premium of 15% to Matravers Co’s shareholders to buy the company.

Westparley Co intends to take advantage of the current values attributed to businesses such as Matravers Tech by selling this part of Matravers Co at the relevant sector price earnings ratio of 18, rather than a forecast estimate of Matravers Tech’s present value of future free cash flows of $4,500m. The company tax rate for both companies is 28% per year.

Post-acquisition cost of capital

The post-acquisition cost of capital of the combined company will be based on its cost of equity and cost of debt. The asset beta post-acquisition can be assumed to be both companies' asset betas weighted in proportion to their current market value of equity.

Westparley Co has 4,000 million $1 shares in issue, currently trading at $8·50. It has $26,000m debt in issue, currently trading at $105 per $100 nominal value. Its equity beta is 1·02.

Matravers Co's asset beta is 0·75. The current market value of Matravers Co's shares is $12,500m and its long-term loan is currently trading at its book value of $6,500m.

The risk-free rate of return is estimated to be 3·5% and the market risk premium is estimated to be 8%. The pre-tax cost of debt of the combined company is expected to be 9·8%. It can be assumed that the debt:equity ratio of the combined company will be the same as Westparley Co's current debt:equity ratio in market values.

The company tax rate for both companies is 28% per year.

Plans for Matravers Co

The offer for Matravers Co will be a cash offer. Any funding required for this offer will be a mixture of debt and equity.

Although for the purposes of the calculation it has been assumed that the overall mix of debt and equity will remain the same, the directors are considering various plans for funding the purchase which could result in a change in Westparley Co's gearing.

As soon as it acquires all of Matravers Co's share capital, Westparley Co would sell Matravers Tech as it does not fit in with Westparley Co's strategic plans and Westparley Co wishes to take advantage of the large values currently attributed to high-technology businesses. Westparley Co would then close Matravers Home's worst-performing city centre stores. It anticipates the loss of returns from these stores would be partly compensated by higher online sales by Matravers Co, generated by increased investment in its online operations. The remaining city centre stores and all out-of-town stores would start selling the food and household items currently sold in Westparley Co's stores, and Westparley Co believes that this would increase profits from those stores.

Westparley Co also feels that reorganising Matravers Co's administrative functions and using increased power as a larger retailer can lead to synergies after the acquisition.

Post-acquisition details

Once Matravers Tech has been sold, Westparley Co estimates that sales revenue from the Matravers Home stores which remain open, together with the online sales from its home business, will be $43,260m in the first year post-acquisition, and this figure is expected to grow by 3% per year in years 2 to 4.

The profit margin before interest and tax is expected to be 6% of sales revenue in years 1 to 4.

Tax allowable depreciation is assumed to be equivalent to the amount of investment needed to maintain existing operations. However, an investment in assets (including working capital) will be required of $630m in year 1. In years 2 to 4, investment in assets each year will be $0·50 of every $1 increase in sales revenue.

After four years, the annual growth rate of free cash flows is expected to be 2% for the foreseeable future.

As well as the free cash flows from Matravers Co, Westparley Co expects that post-tax synergies will arise from its planned reorganisation of Matravers Co as follows in the next three years:

Year	1	2	3
	$m	$m	$m
Free cash flows	700	750	780

The current market value of Matravers Co's shares is $12,500m and its debt is currently trading at its book value of $6,500m.

Required:

(a) Discuss the behavioural factors which may have led to businesses such as Matravers Tech being valued highly. (6 marks)