

Question 03

After having series of discussion with Chairman of SWH PLC the second largest shareholder of the SWH PLC has decided to retire from business and has communicated to the board of directors that he would sell 20% of his shares, if SWH PLC can pay him 20% of company's market valuation, calculated based on earnings before interest, taxes, depreciation and amortization (EBITDA) for the most recent year, adjusted for 40% increase in revenue and cost of sales as further explained below, multiplied by an average industry multiplier. The rest of the key shareholders also have taken this offer seriously as SWH PLC does not have any profitable investment opportunities at the moment due to the global economic downturn.

SWH PLC is planning to use the excess cash including short-term investment held by the company for this purpose and the balance will be financed through a 5-year bank loan.

Adjustments required to the income statement and financial position of SWH PLC for valuation purposes

- The sales will be increased by another 40% while maintaining the same gross profit ratio as the market has correctly identified the growth. Except for the items mentioned, all other income statement items will remain unchanged. The effective corporate tax rate will continue to be at 30%.
- The company has maintained a large short-term investment which has been erroneously classified under trade and other receivables amounting to LKR 3.2 billion.

Required:

As the main shareholder of SWH PLC, chairman is interested in the share repurchase.

Advise the chairman with your independent viewpoint on the proposal, if 20% of shares are going to be repurchased by SWH PLC.

(Your opinion should be supported with an income statement and financial position analysis, valuation-based calculations and qualitative factors, if any).
(14 marks)

However, some of the directors were not clear about the value of the company, in today's terms, and the following two points were posted, for expert advice.

1. An appropriate price range to negotiate with the outgoing shareholder. Directors agreed that the cash flow-based valuation should be reduced by 50%, due to volatile political and economic conditions.

2. The opinion of the finance director that internal financing together with debt financing was not practical, in a share buyback, on financing grounds.

The following information could be used in calculating free cash flows for SWH PLC and assets valuation.

- It is expected that 8% of total assets value has been overstated due to slow moving inventory and assets revaluation concerns.
- Income tax is 30%. Depreciation for the next 5 years starting from 2022/23 amounts to Rs. 500 million per annum approximately.
- “Other operating income” and “Finance income” will also be adjusted for inflation in addition to the operating expenses.
- The free cash flows reported for the year 2026/27 will increase at 3% per year in perpetuity.
- SWH PLC’s book value of debt (non-current and current portion of interest-bearing loans and borrowings) equals the market value.
- Banks agreed to reduce bank loan interest rate in to 18% only for the financial year 2022/23 & 2023/24 as part of the special moratorium plans implemented by the banks to their special customers. General bank loan interest granted by the bank was AWPLR + 1.5% per annum and company expects that AWPLR will reduce to 9% after two years of special moratorium
- Expected gross profits and income tax payments for the next 5 years are as follows.

LKR MN

Year	2022/23	2023/24	2024/25	2025/26	2026/27
Gross Profit	12,488	13,233	13,878	15,670	16,799
Income Tax Payment	1,002	1,445	2,003	2,546	2,987
Capital Expenditure	800	1,350	2,400	670	890
Inflation	15%	13%	9%	5%	3%

* Above information have been adjusted for inflation.

Required:

You have been approached by the CEO to assist him with the two points raised at Meeting
 Recommend a price range to offer for share buyback and comment on the opinion of the finance director that internal financing together with debt financing, is going to be impractical in a share buyback attempt. (16 marks)