
Question 5: Corporate Finance**(28 points)**

Seox is a successful footwear company. Since the Initial Public Offering (IPO), that took place one year ago, the stock price has earned a double-digit increase. Growth was fostered by an intensive program of investments aimed at extending the network of mono-brand shops as well as tapping foreign markets. So far the company has been all-equity financed and the internally generated funds were large enough to finance all new projects. At the end of 2005, Seox is planning to undertake the acquisition of a company that produces leather. In its expansionary strategy the company is assisted by Tom Bullish, a senior manager from an important investment bank. Mr. Bullish has been provided with figures in order to evaluate Seox.

The following tables show the income statements of Seox, the planned capital expenditures (“CAPEX”) (net of disposals) and the net working capital (“NWC”).

Table 1. Seox actual and projected income statements (in Mio EUR)

	2005A	2006E	2007E	2008E
Sales	398	449	553	674
Cost of sales	-187	-202	-243	-289
Advertising	-28	-35	-41	-55
Sales costs	-18	-22	-28	-32
Fixed costs	-56	-67	-81	-94
EBITDA	109	123	160	204
Depreciation	-18	-20	-25	-30
EBIT	91	103	135	174
Taxes	-27.3	-30.9	-40.5	-52.2
Net income	63.7	72.1	94.5	121.8

Table 2. Seox capital expenditures and net working capital (in Mio EUR)

	2005A	2006E	2007E	2008E
CAPEX	23	29	23	39
NWC	39	51	89	111

To estimate the cost of capital of Seox, Mr. Bullish has computed the beta of shares of peer companies, comparable to Seox with respect to the systematic risk of operating cash flows. The equity beta of these peers equals 1.1. Contrary to Seox, peer companies on average have a leverage ratio (D/E) of 1/4 and debt can be considered riskless. The risk free rate is 3.5% and the market risk premium is 4%.

- a) Estimate the free cash flow to the firm (FCFF) of Seox for years 2006, 2007 and 2008. Use the table below to show the calculation paths. (Note: You might not need all the rows to reach the answers.) (12 points)

Cash flows (in Mio. EUR)

	2006	2007	2008
FCFF			

- b) Calculate the cost of capital of Seox. Assume a tax rate of 30%. (6 points)

Mr. Bullish suggests that Seox could finance the acquisition by issuing debt. That would also optimize the capital structure. Suppose Seox issues debt for an amount equal to 1/5 of its unlevered value. Assume debt is riskless and irredeemable and the amount raised is temporarily invested in riskless assets.

- c) Assume the price per share of the unlevered company amounts to 18.24 and that there are 100 million shares outstanding. Determine i) the value of the firm, ii) the value of the equity and iii) the price per share after the debt issue. (10 points)