3 In order to raise funds for future projects, the management of Bento Co, a large manufacturing company, is considering disposing of one of its subsidiary companies, Okazu Co, which is involved in manufacturing rubber tubing. They are considering undertaking the disposal through a management buy-out (MBO) or a management buy-in (MBI). Bento Co wants $60 million from the sale of Okazu Co.

Given below are extracts from the most recent financial statements for Okazu Co:

Year ending 30 April (all amounts in $000)

	2015
Total non-current assets	40,800
Total current assets	12,300
Total assets	53,100
Equity	24,600
Non-current liabilities	16,600
Current liabilities	
Trade and other payables	7,900
Bank overdraft	4,000
Total current liabilities	11,900
Total equity and liabilities	53,100

Year ending 30 April (all amounts in $000)

	2015
Sales revenue	54,900
Operating profit	12,200
Finance costs	1,600
Profit before tax	10,600
Taxation	2,120
Profit for the year	8,480

Notes relating to the financial statements above:

(i) Current assets, non-current assets and the trade and other payables will be transferred to the new company when Okazu Co is sold. The bank overdraft will be repaid by Bento Co prior to the sale of Okazu Co.

(ii) With the exception of the bank overdraft, Bento Co has provided all the financing to Okazu Co. No liabilities, except the trade and other payables specified above, will be transferred to the new company when Okazu Co is sold.

(iii) It is estimated that the market value of the non-current assets is 30% higher than the book value and the market value of the current assets is equivalent to the book value.

(iv) The group finance costs and taxation are allocated by Bento Co to all its subsidiaries in pre-agreed proportions.

Okazu Co's senior management team has approached Dofu Co, a venture capital company, about the proposed MBO. Dofu Co has agreed to provide leveraged finance for a 50% equity stake in the new company on the following basis:

(i) $30 million loan in the form of an 8% bond on which interest is payable annually, based on the loan amount outstanding at the start of each year. The bond will be repaid on the basis of fixed equal annual payments (constituting of interest and principal) over the next four years;

(ii) $20 million loan in the form of a 6% convertible bond on which interest is payable annually. Conversion may be undertaken on the basis of 50 equity shares for every $100 from the beginning of year five onwards;

(iii) 5,000,000 $1 equity shares for $5,000,000.

Okazu Co's senior management will contribute $5,000,000 for 5,000,000 $1 equity shares and own the remaining 50% of the equity stake.

As a condition for providing the finance, Dofu Co will impose a restrictive covenant that the new company's gearing ratio will be no higher than 75% at the end of its first year of operations, and then fall to no higher than 60%, 50% and 40% at the end of year two to year four respectively. The gearing ratio is determined by the book value of debt divided by the combined book values of debt and equity.

After the MBO, it is expected that earnings before interest and tax will increase by 11% per year and annual dividends of 25% on the available earnings will be paid for the next four years. It is expected that the annual growth rate of dividends will reduce by 60% from year five onwards following the MBO. The new company will pay tax at a rate of 20% per year. The new company's cost of equity has been estimated at 12%.

Required:

(a) Distinguish between a management buy-out (MBO) and a management buy-in (MBI). Discuss the relative benefits and drawbacks to Okazu Co if it is disposed through a MBO instead of a MBI. (5 marks)

(b) Estimate, showing all relevant calculations, whether the restrictive covenant imposed by Dofu Co is likely to be met. (12 marks)

(c) Discuss, with supporting calculations, whether or not an MBO would be beneficial for Dofu Co and Okazu Co's senior management team. (8 marks)

(25 marks)