Section A – This ONE question is compulsory and MUST be attempted

1 Cigno Co is a large pharmaceutical company, involved in the research and development (R&D) of medicines and other healthcare products. Over the past few years, Cigno Co has been finding it increasingly difficult to develop new medical products. In response to this, it has followed a strategy of acquiring smaller pharmaceutical companies which already have successful products in the market and/or have products in development which look very promising for the future. It has mainly done this without having to resort to major cost-cutting and has therefore avoided large-scale redundancies. This has meant that not only has Cigno Co performed reasonably well in the stock market, but it has also maintained a high level of corporate reputation.

Anatra Co is involved in two business areas: the first area involves the R&D of medical products, and the second area involves the manufacture of medical and dental equipment. Until recently, Anatra Co's financial performance was falling, but about three years ago a new chief executive officer (CEO) was appointed and she started to turn the company around. Recently, the company has developed and marketed a range of new medical products, and is in the process of developing a range of cancer-fighting medicines. This has resulted in a good performance in the stock market, but many analysts believe that its shares are still trading below their true value. Anatra Co's CEO is of the opinion that the turnaround in the company's fortunes makes it particularly vulnerable to a takeover threat, and she is thinking of defence strategies that the company could undertake to prevent such a threat. In particular, she was thinking of disposing some of the company's assets and focussing on its core business.

Cigno Co is of the opinion that Anatra Co is being held back from achieving its true potential by its equipment manufacturing business and that by separating the two business areas, corporate value can be increased. As a result, it is considering the possibility of acquiring Anatra Co, unbundling the manufacturing business, and then absorbing Anatra Co's R&D of medical products business. Cigno Co estimates that it would need to pay a premium of 35% to Anatra Co's shareholders to buy the company.

Financial information: Anatra Co

Given below are extracts from Anatra Co's latest statement of profit or loss and statement of financial position for the year ended 30 November 2015.

	2015
	$ million
Sales revenue	21,400
Profit before interest and tax (PBIT)	3,210
Interest	720
Pre-tax profit	2,490

	2015
	$ million
Non-current liabilities	9,000
Share capital (50c/share)	3,500
Reserves	4,520

Anatra Co's share of revenue and profits between the two business areas are as follows:

	Medical products R&D	Equipment manufacturing
Share of revenue and profit	70%	30%

Post-acquisition benefits from acquiring Anatra Co

Cigno Co estimates that following the acquisition and unbundling of the manufacturing business, Anatra Co's future sales revenue and profitability of the medical R&D business will be boosted. The annual sales growth rate is expected to be 5% and the profit margin before interest and tax is expected to be 17·25% of sales revenue, for the next four years. It can be assumed that the current tax allowable depreciation will remain equivalent to the amount of investment needed to maintain the current level of operations, but that the company will require an additional investment in assets of 40c for every $1 increase in sales revenue.

After the four years, the annual growth rate of the company's free cash flows is expected to be 3% for the foreseeable future.

Anatra Co's unbundled equipment manufacturing business is expected to be divested through a sell-off, although other options such as a management buy-in were also considered. The value of the sell-off will be based on the medical and dental equipment manufacturing industry. Cigno Co has estimated that Anatra Co's manufacturing business should be valued at a factor of 1·2 times higher than the industry's average price-to-earnings ratio. Currently the industry's average earnings-per-share is 30c and the average share price is $2·40.

Possible additional post-acquisition benefits

Cigno Co estimates that it could achieve further cash flow benefits following the acquisition of Anatra Co, if it undertakes a limited business re-organisation. There is some duplication of the R&D work conducted by Cigno Co and Anatra Co, and the costs related to this duplication could be saved if Cigno Co closes some of its own operations. However, it would mean that many redundancies would have to be made including employees who have worked in Cigno Co for many years. Anatra Co's employees are considered to be better qualified and more able in these areas of duplication, and would therefore not be made redundant.

Cigno Co could also move its headquarters to the country where Anatra Co is based and thereby potentially save a significant amount of tax, other than corporation tax. However, this would mean a loss of revenue for the government where Cigno Co is based.

The company is concerned about how the government and the people of the country where it is based might react to these issues. It has had a long and beneficial relationship with the country and with the country's people.

Cigno Co has estimated that it would save $1,600 million after-tax free cash flows to the firm at the end of the first year as a result of these post-acquisition benefits. These cash flows would increase by 4% every year for the next three years.

Estimating the combined company's weighted average cost of capital

Cigno Co is of the opinion that as a result of acquiring Anatra Co, the cost of capital will be based on the equity beta and the cost of debt of the combined company. The asset beta of the combined company is the individual companies' asset betas weighted in proportion of the individual companies' market value of equity. Cigno Co has a market debt to equity ratio of 40:60 and an equity beta of 1·10.

It can be assumed that the proportion of market value of debt to market value of equity will be maintained after the two companies combine.

Currently, Cigno Co's total firm value (market values of debt and equity combined) is $60,000 million and Anatra Co's asset beta is 0·68.

Additional information

- The estimate of the risk free rate of return is 4·3% and of the market risk premium is 7%.
- The corporation tax rate applicable to all companies is 22%.
- Anatra Co's current share price is $3 per share, and it can be assumed that the book value and the market value of its debt are equivalent.
- The pre-tax cost of debt of the combined company is expected to be 6.0%.

Important note

Cigno Co's board of directors (BoD) does not require any discussion or computations of currency movements or exposure in this report. All calculations are to be presented in $ millions. Currency movements and their management will be considered in a separate report. The BoD also does not expect any discussion or computations relating to the financing of acquisition in this report, other than the information provided above on the estimation of the cost of capital.

Required:

(a) Distinguish between a divestment through a sell-off and a management buy-in as forms of unbundling. (4 marks)

(b) Prepare a report for the board of directors (BoD) of Cigno Co which:

(i) Estimates the value attributable to Cigno Co's shareholders from the acquisition of Anatra Co before taking into account the cash benefits of potential tax savings and redundancies, and then after taking these into account; (18 marks)

(ii) Assesses the value created from (b)(i) above, including a discussion of the estimations made and methods used; (8 marks)

(iii) Advises the BoD on the key factors it should consider in relation to the redundancies and potential tax savings. (4 marks)

Professional marks will be awarded in part (b) for the format, structure and presentation of the report. (4 marks)

(c) Discuss whether the defence strategy suggested by Anatra Co's CEO of disposing assets is feasible. (6 marks)

(d) Takeover regulation, where Anatra Co is based, offers the following conditions aimed at protecting shareholders: the mandatory-bid condition through sell out rights, the principle of equal treatment, and squeeze-out rights.

Required:

Explain the main purpose of each of the three conditions. (6 marks)

(50 marks)