MSC. Accounting and Finance
CF : Session 10

Capital Budgeting Extensions

Session 10 & 11 summary

- Analysis of Mergers and acquisitions
- Strategies for growth
- Justification for growth by acquisition
- Valuation of the acquisition target
- Tactics for acquisitions and mergers
- Success and failure of mergers and takeovers.
- Withdrawal or abandonment,
- Management Buy Outs
- Buy ins, spin offs and sell offs
- Demergers
- Going private
- Symptoms of corporate collapse
- Predicting company failure
- Company liquidations
- Company reconstruction schemes.

Mergers

A merger is the voluntary fusion of two companies on broadly equal terms into one new legal entity. Therefore, it’s a combination of two or more companies into a single company where one survives and the other loses its corporate existence. According to Halsbury’s Laws of England, a Merger is the blending of two or more existing undertakings into one undertaking, the shareholders of each blending company becoming substantially the shareholders in the company which is to carry on the blended undertaking. The shareholders of two companies deciding to pool the companies' resources under a common entity to do the business activity is called a merger. Two companies agree to go forward as a single company rather than separately owned and operated.

Types of mergers

a. Horizontal Mergers.

This involves two firms operating in the same kind of business activity. Both the acquiring and the target company belong to the same industry such as production, distribution, or area of business. The main purpose is to obtain **economies of scale** in production by eliminating duplication of facilities and operations. Motives include eliminating or reducing competition, putting an end to price cutting, economies of scale in production, research and development, better control over marketing and management, and increased market power. Example: NCBA is a merger of National Industrial Credit and Commercial Bank of Africa.

B Vertical Mergers.

This occurs between firms in different stages of production and operation. Expands the adoption of backward integration to adapt sources of supply and forward integration towards market outlets. In the case of an 'Upstream' merger, it extends to the firms supplying raw materials and those that sell eventually to the consumer in the event of a 'downstream' merger. Vertical Forward Integration occurs when the company combines with the customer. Vertical Backward Integration occurs when the company combines with the supplier of materials. Merits include Low buying cost of materials, lower distribution costs, assured supplies, and market, increasing or creating barriers to entry for potential competitors, placing them at a cost disadvantage, control over product specification, and technological economies.

c. Conglomerate Mergers

This occurs between companies engaged in unrelated industries or unrelated lines of business. The rationale for such a merger is diversification of risk. There are three types of Conglomerate merger such as:

- **Product-extension mergers** broaden the product lines of firms. These are mergers between firms in related business activities and may also be called concentric mergers.
- **Geographic market-extension merger** involves two firms whose operations have been conducted in non-overlapping geographic areas. (Pizza Hut)
- **Pure conglomerate mergers** involve unrelated business activities. These would not qualify as either product extensions or market extensions. Have new products & new territories. Examples in Uganda include BMK Group, New Vision Group, Mulwana Group, and DFCU Group. d

Concentric Mergers & Circular Combination.

d. Concentric Mergers.

A merger in which there is carry–over in specific management functions such as marketing or complementarily in relative strengths among specific management functions rather than carryover/complementarities in only generic management functions such as planning. Firms seeking to diversify from advanced technology industries may be strong on research but weaker on production and marketing, capabilities firms in industries with less advanced technology.

e. Circular Combination

This happens among companies producing distinct products to share common research and distribution facilities to obtain economies by eliminating cost of duplication and promoting market enlargement. Acquiring a company has the benefit in the form of economies of resource sharing and diversification. When firms belonging to different industries and producing altogether different products combine under the banner of a central agency it is referred to as mixed or circular mergers. Example: Merger of Sony (camera provider for mobiles) and Ericsson (cell phone producer).

Advantages of mergers

- Combining resources can lead to cost savings and increased efficiency.
- Larger market presence can lead to increased bargaining power.
- Increased market share, which means more customers and greater influence.
- Improved Research and Development, which means more innovation and quality.
- Reduced competition, which means less pressure and higher prices.
- **Economies of scale:** This refers to the fact that the combined company can often reduce its fixed costs by removing duplicate departments or operations, lowering the costs of the company relative to the same revenue stream, thus increasing profit margins.

Advantages of mergers continuation

- Economies of scope: This refers to the efficiencies primarily associated with demand-side changes, such as increasing or decreasing the scope of marketing and distribution of different types of products.
- Increased revenue or market share: This assumes that the buyer will absorb a major competitor and thus increase its market power (by capturing increased market share) to set prices.
- Cross-selling: For example, a bank buying a stock broker could then sell its banking products to its customers, while the broker can sign up the bank's customers for brokerage accounts. Or, a manufacturer can acquire and sell complementary products.

Advantages of mergers continuation

- **Synergy:** For example, managerial economies such as the increased opportunity of managerial specialization. Another example is purchasing economies due to increased order size and associated bulk-buying discounts.
- **Taxation:** A profitable company can buy a loss maker to use the target's loss as their advantage by reducing their tax liability. In the United States and many other countries, rules are in place to limit the ability of profitable companies to "shop" for loss-making companies, limiting the tax motive of an acquiring company.
- **Geographical or other diversification**: This is designed to smooth the earnings results of a company, which over the long term smoothens the stock price of a company, giving conservative investors more confidence in investing in the company. However, this does not always deliver value to shareholders.
- **Resource transfer:** resources are unevenly distributed across firms (Barney, 1991) and the interaction of target and acquiring firm resources can create value through either overcoming information asymmetry or by combining scarce resources.

Disadvantages of mergers

- Integration challenges can arise from differing corporate cultures.
- Mergers may face antitrust scrutiny and regulatory hurdles.
- Increased prices of products or services due to reduced competition and increased market share
- Increased unemployment due to overlapping staff and cost-cutting measures
- Communication and coordination problems due to different cultures and organizational structures.
- Diseconomies of scale due to the increased size and complexity of the merged firm.
- Decreased innovation and choice for consumers due to less incentive and competition.

Takeover Takeovers

Takeovers may be defined as “a transaction or series of transactions whereby an individual or group of individuals or company acquires control over the company's management by acquiring equity shares carrying majority voting power”. It can be an acquisition of shares carrying voting rights in a company to gain control over the assets and management of the company. In a takeover, the seller management is an unwilling partner and the purchaser will generally resort to acquiring controlling interest in shares with very little advance information about the company which is being bought.

Takeover Takeovers continuation

If shares totaling 51% of the total value of capital are held by the acquirer and his associates, the takeover is complete and the acquirer gets a status similar to that of a holding company. In most of the corporate, there exists a concept called controlling interest. They can be voluntary, meaning they are the result of a mutual decision between the two companies. In other cases, they may be unwelcome, in which case the acquirer goes after the target without its knowledge or sometimes without its full agreement. Example: Marsh Holdings by Old Mutual Zimbabwe Limited, Zimco Group Proprietary

Types of takeovers.

a. Friendly Takeovers. In a friendly takeover, the acquirer will purchase the controlling shares after thorough negotiations and agreement with the seller. The takeover bid is finalized with the consent of the majority shareholders of the target company. This form of purchase is also called a “consent takeover”.

b. Hostile Takeovers. A person seeking control over a company, purchases the required number of shares from noncontrolling shareholders in the open market. This method normally involves purchasing of small holdings of small shareholders over some time at various places. As a strategy, the purchaser keeps his identity a secret. Example: Vodafone and Mannesmann $202.8 billion in 1999, Twitter by Elon Musk.

Types of takeovers continuation

c. Bailout Takeover. These forms of takeover are resorted to bailout the sick companies to allow the company for rehabilitation as per the schemes approved by the financial institutions. The lead financial institutions will evaluate the bids received for acquisitions, the financial position and the track record of the acquirer.

d. Reverse takeovers. A "reverse takeover" is a type of takeover where a private company acquires a public company. This is usually done at the instigation of the larger, private company, the purpose being for the private company to effectively float itself while avoiding some of the expense and time involved in a conventional IPO.

e. Backflip takeovers. A "backflip takeover" also known as "a creeping takeover" is any sort of takeover in which the acquiring company turns itself into a subsidiary of the purchased company. This type of takeover can occur when a larger but less well-known company purchases a struggling company with a very well-known brand. Examples include The Texas Air Corporation takeover of Continental Airlines but taking the Continental name as it was better known. NationsBank's takeover of the Bank of America, but adopting Bank of America's name. C

Companies that make attractive takeover targets include;

- Those with a unique niche in a particular product or service.
- Companies with good potential value but management challenges.
- Small companies with viable products or services but insufficient financing.
- Similar companies in close geographic proximity where combining forces could improve efficiency.
- Viable companies that pay too much for debt that could be refinanced at a lower cost if a larger company with better credit took over.

Merits of Takeovers.

- Increase market share.
- Increase in economies of scale.
- Profitability of target company.
- Expand strategic distribution network.
- Venture into new businesses and markets.
- Reduction of overcapacity in the industry.
- Enlarge brand portfolio (L'Oréal's takeover of Body Shop).
- Increase in sales/revenues (Procter & Gamble takeover of Gillette)
- Increased efficiency as a result of corporate synergies/redundancies.
- Access to specialized skills and talent within the acquired company.
- Decreased competition (From the perspective of the acquiring company)

Demerits of takeovers.

- Likelihood of job cuts.
- The monetary cost to the company.
- Hidden liabilities of the target entity.
- Goodwill, often paid in excess for the acquisition.
- Cultural integration/conflict with new management.
- Lack of motivation for employees in the company being bought.
- Culture clashes within the two companies cause employees to be less efficient/despondent.
- Reduced competition and choice for consumers in oligopoly markets (Bad for consumers, although this is good for the companies involved in the takeover).

Acquisitions

An acquisition is the purchase of one business or company by another company or other business entity. The acquisition means acquiring ownership of the company. When 2 companies become one, but with the name and control of the acquirer, and the control goes automatically into the hands of the acquirer. Such purchase may be of 100%, or nearly 100% of the assets or ownership equity of the acquired entity. An acquisition may be private or public, depending on whether the acquiree or merging company is or isn't listed in public markets. An acquisition may be **friendly or hostile**. Whether a purchase is perceived as friendly or hostile depends on how it is communicated to and received by the target company's board of directors, employees and shareholders. Example Sanlam, has acquired a 100 percent stake in Lion Assurance Company Limited for $ 6.5 million, Google and Android. In 2005, Meta and Instagram and What’s App.

Advantages of acquisitions

- Access to capital is greatly increased and improved.
- Acquiring established brands or market presence.
- Helpful in gaining a competitive edge in the marketplace.
- Helps to increase the market share of your company quickly.
- To gain competencies and resources it does not hold currently.
- Allow companies to strategically acquire specific assets or capabilities.
- Helps to overcome market entry barriers that were previously challenging.
- Access to experts and specialists such as financial, legal, or human resource specialists.
- Fresh ideas and perspectives from experts who are passionate about the business reach its goals.

Disadvantages of acquisitions

- Integrating operations and cultures can be complex.
- Acquiring companies may overpay for the target, leading to financial strain.
- Culture clashes between the acquiring and the acquired firm which may breed antagonism and anxiety.
- Acquisitions may lead to employees duplicating each other's duties. This can cause excessive costs on wages.
- Job cuts to maximize efficiencies thus, may reduce employee morale and lead to low productivity.
- Pressure on suppliers may create production problems.
- Brand damage of the new company or damage to the existing brand

Strategies for Valuation of shares/ companies:

Reasons for share / Company valuations

- **For Quoted companies** when there is a takeover bid and the offer price is an estimated 'Fair Value' in excess of the current market price of the shares. Otherwise the share price is determines by market conditions on the stock exchange.

For Un-quoted companies, When

- The company wishes to get floated on stock exchange and must fix an issue price for its shares.
- There is a proposal scheme for a merger
- Shares are to be sold
- Shares need to be valued for purposes of taxation.
- Shares are pledged as collateral for a loan.

Valuation of shares/ companies

- **For Subsidiary companies,** when the holding company is negotiating the sale of the subsidiary to a management Buyout team or to an external buyer.
- Usually, valuing unquoted companies presents some special considerations. For example,
- It may not be sensible to use a P/E ratio of a quoted company for comparative purposes because the market value of a quoted company is likely to include a premium to reflect marketability of its shares.
- It may not be sensible to use the Cost of Equity of a quoted company to compare because the Cost of capital for a quoted company is likely to be much lower to reflect the fact that it is viewed as less risky by investors.

COMMON BASES FOR VALUING SHARES

1. Asset Based valuation method
2. Earnings Based – P/E Ratios, Earnings Yield, ARR
3. Cash flow Based- Dividends DCF
4. Dividends Growth model

1. Asset Valuation Bases

- Using this method of valuation, the value of a share in a particular class is equal to the ***net tangible assets attributable to that class, divided by the number of shares in that class***. Intangible assets should be excluded, unless they have a market value (for example patents and copyrights which could be sold.)
- Goodwill if shown in accounts is unlikely to be shown at a true figure for purposes of valuation and so the value of goodwill should not be reflected in net assets method.
- Development expenditure if shown in accounts would have a value which is related to future profits rather than the worth of the company's physical assets.

Asset Valuation Bases

However, there are three common ways of valuing its net assets and these include Book values, Net Realizable Values and Replacement values.

a) **The Book value method**

An adjusted book value is a measure of a company's valuation after liabilities, including off balance sheet liabilities, and assets are adjusted to reflect true fair market value

b) **Net realizable value method** This is basically net realizable values of the assets less liabilities.

c) **Replacement value method** This approach tries to determine what it would cost to set up the business if it were being started now. The value of a successful business using replacement values is likely to be lower than its true value unless an estimate is made for the value of goodwill and other intangible assets, such as brands. Furthermore, estimating the replacement cost of a variety of assets of different ages can be difficult. Therefore, of the three (3) assets-based methods, the net realizable value method is the best method

Example:

To find the asset values, we *start* with the Balance Sheet values, and then *adjust* them in the light of the information given in the question. For example:

Raspberry Ltd		**£'000**	**£ '000'**
Land and Buildings		1,000	
Plant and Machinery		400	
			1,400
Stocks	450		
Debtors	250		
Cash	100		
Less			
Trade Creditors	350		
Bank Overdraft	150		300
Net Assets			1,700
Financed by:			
Issued Share Capital (SHS 0.25)		500	
Reserves		1,000	
Shareholders Funds			1,500
Longer-Term Debt			200
			1,700

Example

- It is thought that the land and buildings could be sold off for £1.8m.
- The plant and machinery have a sale value of £250,000 and a replacement cost of

  £300,000.
- The balance sheet figure for stock is thought to include £50,000 of obsolete stocks that could be sold off for £10,000, and
- The debtors figure contains a doubtful debt of £10,000.

Solution

In the light of this information, the revised value of the assets would be:

			£000s
Land and Buildings			1,800
Plant and Machinery			300
			2,100
Stocks		410	
Debtors		240	
Cash	100		
Less			
Trade Creditors	350		
Bank Overdraft	150	250	
Net Assets		2.350	

Solution

Notice that in adjusting the balance sheet figures:

- As in the case of land and buildings – sale value is preferred to book value.
- But, as in the case of Plant and Machinery – replacement cost is preferred to both sale value and book value.
- The examiner’s thinking here is as follows: Sale value has more economic reality than a book value; but sale value is really a “break-up value” concept, (and invariably, we are valuing the company as a going concern). Therefore, when given the choice between sale value and replacement cost, then replacement cost is more meaningful to use within a going concern context.

Solution

As a result of these adjustments:

Value of the Equity = £2.35m. - £0.2m. = **£2.15m**

and the Value per Share = £2.15m. ÷ 2m. shares = **107.5p**

Problems of Assets based valuation approach:

There are two main problems with this valuation approach:

- In practice, realistic asset values are very difficult to identify, and
- The technique only values the *tangible* assets; and ignores the company's **intellectual assets**, (*or knowledge assets*) It is this second point that is the most important.

The Net Asset method may be used in the following circumstances

- As a measure of the security in a share value. A share could be measured using an earnings basis and this valuation could be:
  - Higher than the net asset value per share, i.e. if the company went into liquidation, the investor could not expect to receive the full value of his shares from sale of underlying assets.
  - Lower than the net asset value per share i.e. if the company is sold, the investor could expect to receive the full value of his shares and perhaps much more, when underlying assets are sold.
- As a measure of comparison in a merger scheme. A merger is basically a business combination between two or more companies, of which none obtains control over any other.
- As a 'Floor value' or reserve value for a business that is up for sale. Shareholders will be reluctant to sell at a value less than Net asset value.

Class exercise

a) Using hypothetically designed examples, discuss the various methods of valuing companies and their shares that are available to you.

b) Nile indigenous ltd (NIL) is a company resident in Uganda and has been in the business of selling second hand clothes in big cities and towns of Uganda for the last 10 years. Its head office is located in Kampala with branches in all major regions of the country. The company wishes to get floated on the Uganda stock exchange and must fix an issue price for its shares. The data provided by the finance manager in form of audited statement of financial position as at 31st December, 2016 is given below:

Nile indigenous ltd (NIL) Statement of financial position

As at 31st December, 2016

	SHS. 'million'	SHS.' million'
Land and Buildings	1,000	
Plant and Machinery	400	
		1,400
Stocks	450	
Debtors	250	
Cash	100	
Less:		
Trade Creditors	350	
Bank Overdraft	150	300
Net Assets		1,700
Financed by:		
Issued Share Capital (SH. 250)	500	
Reserves	1,000	
Shareholders' Funds		1,500
Longer-Term Debt		200
		1,700

Class exercise

Additional information;

i. It is anticipated that the land and buildings could be sold off for SHS. 1, 400,000,000.

ii. The plant and machinery have a sale value of SHS.350, 000,000 and a replacement cost of SHS. 400,000,000.

iii. The Statement of financial position figure for stock is thought to include SHS. 60,000,000 of obsolete clothes partly destroyed in the store by rats. These clothes could be sold off for SHS.8, 000,000 and the debtors figure contains a doubtful debt of SHS. 11,000,000.

iv. Nile paid a dividend of SHS. 35,000,000 this year. The current return to shareholders of companies selling second hand clothes in the same industry as Ronald and sons ltd is 13%, although it is expected that an additional risk premium of 3% will be applicable to Ronald and sons ltd, being a medium and unquoted company

v. The creditors figure includes SHS. 50,000,000 owed to Government that was recently waived off

Group exercise

Required:

Basing on the information provided:

a) Identify and discuss any other reasons for valuing companies that are not mentioned in the above case.

b) Discuss the major differences and limitations associated with Net assets and dividend valuation methods

c) Apply Net assets valuation method to advise the management of Nile indigenous ltd (NIL) on the Value of the entire company's equity and Value per Share

d) Compute the value of Nile indigenous ltd (NIL) if the current level of dividend is expected :

i. To continue in perpetuity

ii. To grow at a rate of 5% p.a.

2. Relative valuation techniques/ Earnings Based methods

This is where the value of stock is estimated basing upon its current price relative to variables considered to be significant to valuation such as earnings, cash flow, and book value or sales. They include the price to earnings ratio (P/E), the price to cash flow ratio (P/CF), price to book value ratio (P/BV) and the price/sales ratio (P/S). Although there are several techniques as outlined above, the most commonly used relative valuation techniques are the P/E ratio and ARR methods that we are about to discuss

a) The P/E Ratio method

This is a common method of valuing a controlling interest in a company, where the owner can decide on a dividend and retention policy.

- Since P/E ratio = $\frac{\text{Market Value (p)}}{\text{EPS}}$
- Then the Market price per share = EPS x P/E ratio *NB Please recall that:*

$$EPS = \frac{\textit{Profit/Loss attributable to ordinary share holders}}{\textit{Weighted Average number of ordinary shares in the year}}$$

- The P/E ratio produces an earnings based valuation of shares.
- The higher the P/E ratio, the higher will be the price. A high P/E ratio indicates;

Indications of A high P/E ratio

- **Expectations that EPS will grow rapidly**. In other words, a high price is being paid now for future profit prospects.
- **Security of Earnings,** - a well established low-risk company would be valued on a higher P/E Ratio than a similar company whose earnings are subject to high uncertainty.
- **Status;** If a quoted company (the predator) made a share for share takeover bid, for an unquoted company(the target), it would normally expect its own shares to be valued on a higher P/E ratio than the target company's shares. This is because a quoted company ought to be a lower risk company; and in addition there is an advantage in holding shares which are quoted on the stock exchange, as these can be readily sold on the secondary market.

P/E ratio continued

- When a company is thinking of taking over another, it should look at the target company's forecast earnings, not just its historical results.

Forecasts of earnings should only be used if;

- There are good reasons to believe that earnings growth will be achieved.
- A reasonable estimate of growth can be made
- Forecasts supplied by the target company's directors are made in good faith.

Formula for calculating P.E ratio

$$\text{P. E / Earnings multiplier} = \frac{\text{Market value per share}}{\text{EPS}}$$

Hence market value = P/E ratio X EPS

Example 1

If a company is currently trading at SHS.4,300 a share and earnings over the last 12 months were SHS.195 per share, the P/E ratio for the stock would be calculated as follows:

$$\frac{4300}{195} = 22.05$$

Example 2

MSAC 2024 ltd has paid a constant dividend of shs.84 per share per annum for some years and is expected to continue doing so in the future. A current dividend is about to be paid. Shareholders expect a return of 14% per annum on their investment. Determine the expected share value for MSAC 2024 ltd.

P/E = 84 ÷ 0.14 = **600**

Therefore the expected share value **=** 600+84

=<u>SHS.684</u>

ARR method

- An ARR Valuation could be used in a takeover when the Acquiring company is trying to assess the maximum amount it can afford to pay.
- This method considers the ARR which will be required from the company whose shares are to be valued. It is different from the P/E ratio which is concerned with the market rate of return required. The following formula should be used;

$$\text{Value} = \frac{\text{Estimated future Profits}}{\text{Required return on capital employed}}$$

ARR method

- For a takeover bid valuation, it is often necessary to adjust the profits figure to allow for expected changes after the takeover.
- New levels of director’s remuneration
- New levels of interest charges (for example if predator will be able to replace existing loans at lower interest rates or because the previous owners had lent the company money at non commercial rates.
- Effects of product rationalization and improved management.

Example on ARR

Example

Chambers ltd is considering acquiring hall ltd. At present, Hall ltd is earning on average 480,000,000 shs after tax. The directors of chambers feel that after re-organisation, this figure could be increased to 600,000,000 shs. All companies in chambers group are expected to yield a post tax ARR of 15% on capital employed. What should Hall ltd be valued at?

Solution

$$\text{Valuation of Hall} = \frac{600{,}000{,}000}{15\%} = 4{,}000{,}000{,}000/=$$

this is the maximum that chamber would be prepared to pay. The first offer could be probably much lower than this.

Earnings yield method

This method values a company based on its earnings yield, which is the inverse of the Price/Earnings ratio. It shows the percentage of a company's earnings per share. Earnings yield is used by many investment managers to determine optimal asset allocations and is used by investors to determine which assets seem **underpriced or overpriced** so as to make informed decisions.

For example, If Company A has a price/earnings ratio of 32, its earnings yield would be 32/128 = 25%. If Company B has a price/earnings ratio of 24, its earnings yield would be 24/60 = 40%. Therefore, the acquisition of Company B by Company A is a viable decision because Company B has a higher earnings yield of 40%

c) Earnings yield method

i. The Dividend yield method of share valuation

The Dividend yield method is suitable for the valuation of small share holdings in unquoted companies. It is based on the principle that small shareholders are mainly interested in dividends, since they cannot control decisions affecting the company's profits and earnings. A suitable offer price would therefore be one, which compensates them for future dividends they will be giving up if they sell their shares.

$$\text{Dividend yield} = \frac{\text{Dividend per share x } 100\%}{\text{Market Value per share}}$$

$$\text{Market value} = \frac{\text{Dividend}}{\text{Dividend yield}}$$

3. Discounted Cash Flow (DCF)

This refers to a valuation method that estimates the value of an investment using its expected future cash flows. DCF analysis attempts to determine the value of an investment today, based on projections of how much money that investment will generate in the future. It can help those considering whether to acquire a company or buy securities. Discounted cash flow analysis can also assist business owners and managers in making capital budgeting or operating expenditures decisions. For example, company XYZ has 1,000,000 outstanding shares, expected to generate cash flows of $2 million annually for the next four years and its cost of capital is usually 12% per annum.

Required: Compute the current market value of this company.

3. Discounted cash flow method of share valuation continuation

This method is most appropriate when one company intends to buy the assets of another company and to make further investments in order to improve cash flows in future. (Recall all NPV fundamentals. Positive NPV, negative NPV, Acceptance criteria and Discounting)

DCFs continued

- All of these techniques are based on the basic valuation model which asserts that the value of an investment is the present value of all expected future cash flows that is, cash flows discounted to present value.
- While the concept behind discounted cash flow analysis is simple, its practical application can be a different matter. The premise of the discounted cash flow method is that the current value of a company is simply the present value of its future cash flows that are attributable to shareholders.

The Dividend Valuation Model.

The dividend Valuation model is also known as the dividend discount model (DDM). The dividend valuation model is used in the determination of the current share price by discounting the expected future dividend payments. In other words, the discounted future dividend payments reflect the market price for a company's shares. It attempts to calculate the fair value of a stock irrespective of the prevailing market conditions and takes into consideration the dividend payout factors and the market expected returns. If the value obtained from the DDM is higher than the current trading price of shares, then the stock is undervalued and qualifies for a buy, and vice versa.

The Dividend Valuation Model continuation

The dividend valuation model assumes that the value of a share will be the discounted present value of all expected future dividends on the share, discounted at the share holder’s cost of Capital.

The value of an ordinary share will be the present value of the expected future dividends from the particular share.

The Dividend valuation model continued

The value of an ordinary share (*P0) can be expressed as* follows:

$$\boldsymbol{P0 = \frac{D1}{(1 + Ke)^1} + \frac{D2}{(1+ Ke)^2} + \text{-----} \frac{D3}{(1 + Ke)^3} + \frac{Dn}{(1 + Ke)^n}}$$

- where *P0 = the current market value of the share*
- *D = the expected future dividend in years 1 to n*
- *n = the number of years over which the business expects to issue dividends*
- *Ke = the cost of ordinary shares to the business (that is, the required return for* investors).

Formula for DCF

OR;

$= CF_1/(1+i)^1 + CF_2/(1+i)^2 + CF_3\ (1+i)^3 + \ldots + CF_t/(1+i)^n$	
$V_0 = CF_t\ /\ (1+i)^n$	
V_0	= value of asset at time zero
CF_t	= cash flow expected at the end of year t
I	= discount rate (WACC)
N	= time period

This method is widely used by business valuators and has become accepted in many legal contexts.

Ordinary (equity) shares

The valuation model above can be used to determine the *cost of ordinary shares to* the business (*Ke). Assuming the value of an ordinary share and the expected future* dividends are known, the cost of an ordinary shares will be the discount rate that, when applied to the stream of expected future dividends, will produce a present value that is equal to the current market value of the share. Thus, the required rate of return for ordinary share investors (that is, the cost of ordinary shares to the business) is similar to the internal rate of return (IRR) used to evaluate investment projects.

Valuing shares with Zero growth in dividends

$$\text{Zero Growth}: P_0 = \frac{\text{Div}}{r}$$

Where:
P = the price at time 0
r = discount rate

for simplicity's sake, consider a company with a SHS.1, 000 annual dividend. If you figure the company will pay that dividend indefinitely, you must ask yourself what you are willing to pay for that company. Assume expected return, or, more appropriately in academic parlance, the required rate of return is 5%. According to the dividend discount model, the company should be worth SHS.1, 000 / .05) = SHS.20, 000

Valuing shares with Zero growth in dividends

How do we get to the formula above? It's actually just an application of the formula for a perpetuity:

$$P_0 = \frac{Div_1}{1+r} + \frac{Div_2}{(1+r)^2} + \ldots = \frac{Div}{r}$$

Valuing Ordinary (equity) shares with constant dividend growth

The first assumption is that dividends will remain constant overtime. Where dividends are expected to remain constant for an infinite period, the fairly complicated equation to deduce the current market value of a share stated above can be

reduced to,

$$P0 = \frac{D1}{Ke}$$

where *D1 = the annual dividend per share in year 1 (which, assuming a constant* dividend, will also be the annual dividend in perpetuity.

Ke = *cost of equity*

Valuing Ordinary (equity) shares with constant dividend growth

This equation (which is the equation for capitalizing a perpetual annuity) can be rearranged to provide an equation for calculating the *cost of ordinary shares (ke) to the* business. Hence:

$$Ke = \frac{D1}{P0}$$

Valuing Ordinary (equity) shares with constant dividend growth

The second simplifying assumption that may be employed is that dividends will grow at a constant rate over time. Where dividends are expected to have a constant growth rate, the equation to deduce the current market value of a share can be reduced to,

$$P0 = \frac{D1}{Ke - g}$$

where *g is the expected annual growth rate. (The model assumes Ke is greater than g).*This equation can also be rearranged to provide an equation for calculating the *cost of* ordinary share capital. Hence:

$$Ke = \frac{D1}{P0} + g$$

This is sometimes referred to as *Gordon's growth model after the name of the person* credited with developing it.

4. Dividends growth model

b) Dividend Growth Model

The obvious shortcoming of the model above is that you'd expect most companies to grow over time. If you think this is the case, then the denominator equals the expected return less the dividend growth rate. This is known as the constant growth DDM

The formula for valuing a company with a constantly growing dividend is as follows;

$$\text{Constant Growth: } P_0 = \frac{\text{Div}}{r - g}$$

$$P_0 = \frac{\text{Div}}{1+r} + \frac{\text{Div}(1+g)}{(1+r)^2} + \frac{\text{Div}(1+g)^2}{(1+r)^3} + \dots = \frac{\text{Div}}{r-g}$$

Example

Target ltd paid a dividend of 25,000,000 this year. The current return to share holders of companies in the same industry as target plc is 12%, although it is expected that an additional risk premium of 2% will be applicable to Target, being a smaller and unquoted company. Compute the value of Target ltd

a) if the current level of dividend is to continue in perpetuity

b) if the dividend is expected to grow at a rate of 4% pa

Answer for on dividend valuation example

Solution.

Ke = 12% +2% =14% or 0.14 D_0= 25,000,000 g in ii) =4%

i) $P_0 = D_0/ke = \frac{25,000,000}{0.14} = 178,571,400/=$

ii) $\frac{D_0(1+g)}{Ke-g} = \frac{25,000,000(1+0.04)}{0.14-0.04} = 260,000,000/=$

Example on Discounted cash flow method

Diversification ltd wishes to make a bid for Tadpole ltd. Tadpole makes an after tax profit of 40,000,000 a year. Diversification believes that if further money is spent on additional investments, the after tax cash flows (ignoring purchase consideration) would be as follows

Year	Cash flow '000' (net of tax)
0	(100,000)
1	(80,000)
2	60,000
3	100,000
4	150,000
5	150,000

Example on Discounted cash flow method

The After tax cost of capital of Diversification ltd is 15% and the company expects all its investments to pay back, in discounted terms, within five years. What is the maximum price that Diversification ltd. should be willing to pay for Tadpole ltd?

Solution on Discounted cash flow method

The maximum price is one which would make the return from the total investment exactly 15% over the five years so that the NPV at 15% would be zero.

Year	Cash flow '000(net of tax)	PV factor (15%)	PV '000
0	(100,000)	1.000	(100,000)
1	(80,000)	0.870	(69,600)
2	60,000	0.756	45,360
3	100,000	0.658	65,800
4	150,000	0.572	85,800
5	150,000	0.497	74,550
Maximum purchase price			**101,910**

The Net Assets Basis Method.

This is a business valuation model that focuses on and values a company based on its net asset value. The net asset value is identified by subtracting total liabilities from total assets. There is some room for interpretation in terms of deciding which of the company's assets and liabilities to include in the valuation and how to measure the worth of each. For example, If Company A has total assets of $1.6 billion and total liabilities of $800 million, its net assets would be $800 million. If Company B has total assets of $600 million and total liabilities of $200 million, its net assets would be $400 million.

Example

Assume that company A intends to acquire company B by issue of common stock. The finance data on the potential acquisition at the time of consideration was as follows:

	Company A	Company B
Present earnings	800,000,000	400,0000,000
Shares outstanding	200,000,000	160,000,000
Price per share	128	60
Earnings per share	4	2.5
Price/earnings ratio	32	24

Example continued

Company B agrees to an offer of SHS. 800 per share to be paid in company A's stock for each share of company B.

You are Required to:

a) To ascertain the post- merger position of the acquiring company A at the acquisition price of SHS.800
b) Using the same companies, A and B, supposing that the price offered and agreed upon per share to be paid in company A's stock for each share of B is SHS.900 instead of SHS.800 per share, determiner the post- merger position of A at the acquisition price of SHS.900

Ascertaining the post- merger position of the acquiring company A at the acquisition price of SHS.800

Step 1: Determine the shares to be issued by Company A as follows:

Shares to be issued =

$$\frac{Offer\ Price\ of\ \ \ \ Company\ B}{Market\ Price\ of\ Company\ A}$$

$$= \frac{800}{128} = \qquad 6.25$$

Therefore, for each share of Company B 6.25 Shares of Company A will be issued.

Ascertaining the post- merger position of the acquiring company A at the acquisition price of SHS.800

Total New Shares to be issued =

$$\frac{Offer\ Price\ of\ Company\ B}{Market\ Price\ of\ Company\ A} \text{ x Shares of co. B}$$

= 800/128 X 160,000,000 =1,000,000,000 shares

Step 2: Determine the total number of shares outstanding for company A after the merger.

Total no. of shares = Shares of A before merger + shares of company A after merger. =

200,000,000 + 1,000,000,000 = 1,200,000,000 Shares

Ascertaining the post- merger position of the acquiring company A at the acquisition price of SHS.800

Step 3: Determine the New EPS for Company A after the Merger.

Total New Shares to be issued =

$$\frac{Total\ Earnings\ (A+B)}{Total\ shares\ of\ Company\ \text{A}}$$

$$= \frac{800M+400M}{1{,}200{,}000{,}000} = \frac{1{,}200{,}000{,}000}{1{,}200{,}000{,}000}$$

New EPS = 1

Ascertaining the post- merger position of the acquiring company A at the acquisition price of SHS.800

Step 4: Determine the Price-to-earnings ratio paid

Price to earnings ratio paid =

$$\frac{Offer\ Price\ of\ Company\ B}{EPS\ of\ targets}$$

800 / 2.5 = 320

Step 5: Compare Price to price-to-earnings ratio to the current Price-to-earnings ratio.

Current Price-to-earnings ratio = $32

Price to earnings ratio = $320

Growth rate = $\frac{\text{Price to earnings ratio}}{\text{Current Price to earnings ratio}}$

= 320 /32 = 10 times.

Therefore, the value of Company A will grow by 10 times after the merger.

Determination of the post-merger position of Company A at an acquisition price of Shs. 900

Step 1: Determine the shares to be issued by Company A as follows:

Shares to be issued =

$$\frac{Offer\ Price\ of\ \ \ \ Company\ B}{Market\ Price\ of\ Company\ \text{A}}$$

$$= \frac{900}{128} = \qquad 7.03$$

Therefore, for each share of Company B 7.03 Shares of Company A will be issued.

Determination of the post-merger position of Company A at an acquisition price of Shs. 900

Total New Shares to be issued =

$$\frac{Offer\ Price\ of\ Company\ B}{Market\ Price\ of\ Company\ A} \text{ x Shares of co. B}$$

= 900/128 X 160,000,000 ==1,125,000,000 shares

Step 2: Determine the total number of shares outstanding for company A after the merger.

Total no. of shares = Shares of A before merger + shares of company A after merger. =

200,000,000 + 1,125,000,000 = 1,325,000,000 shares

Determination of the post-merger position of Company A at an acquisition price of Shs. 900

Step 3: Determine the New EPS for Company A after the Merger.

Total New Shares to be issued =

$$\frac{Total\ Earnings\ (A+B)}{Total\ shares\ of\ Company\ \mathrm{A}}$$

$$= \frac{800M+400M}{1{,}325{,}000{,}000}$$

New EPS = 0.091

Determination of the post-merger position of Company A at an acquisition price of Shs. 900

Step 4: Price-to-earnings ratio paid Price to earnings ratio paid =

$$\frac{Offer\ Price\ of\ Company\ B}{EPS\ of\ targets}$$

900 / 2.5 = 360

Step 5: Compare Price to price-to-earnings ratio to the current Price-to-earnings ratio.

Current Price-to-earnings ratio = $32

Price to earnings ratio = $320

Growth rate = $\frac{\text{Price to earnings ratio}}{\text{Current Price to earnings ratio}}$

= 360 /32 = 11.25 times.

Therefore, the value of Company A will grow by 11.25 times after the merger.

Strategies for corporation growth

Withdrawal or Abandonment

Exiting unprofitable or non-core business operations. Example: Game, Nakumatt, Shoprite, and Uchumi in Uganda.

Advantages:

1. Allows the company to concentrate resources on core operations.
2. Eliminates expenses associated with underperforming ventures.
3. Disadvantages:

1. Withdrawal may result in missed potential for future growth.

2. Perception of instability or failure impacting companies' reputation.

Management Buyouts (MBOs)

A management buyout (MBO) is a form of acquisition where a company's existing managers buy or acquire a large part of the company. Management will have to pay a premium over the current market price to entire public shareholders to go along with the deal. Management buyouts involve the current management team of a company purchasing the business from its owners or shareholders. If management has to borrow heavily to finance the transaction, it is called a Leveraged Buyout (LBO). Managers may want to buy their company for several reasons: They want to avoid being taken over by a raider who would bring in new management, they no longer want the scrutiny that comes with running a public company or they believe they can make more money for themselves in the long run by owning a larger share of the company, and eventually reap substantial profits by going public again with a Reverse Leveraged Buyout.

Advantages of a Management Buyout

Advantages of a Management Buyout

- MBOs offer a simple and quick way to sell a business, as buyers are already in-house, reducing the need for marketing.
- Confidentiality is maintained, and companies purchased through MBOs have a higher chance of success.
- MBOs also reduce competition, increase profits, and provide access to new technology or products.

Disadvantages of a Management Buyout

Management buyouts can face several challenges, including

- Difficulties in raising funds.
- Lack of business ownership experience.
- Insider trading risks.
- Managing the owner's departure.
- Loss of key personnel
- Integration of personnel and procedures.
- Large amounts of debt, decreased productivity, and resistance

Examples

- Michael Dell paid $25 billion to take the company he founded, Dell Computers, private in 2013.
- Michael Lines of PricewaterhouseCoopers led an MBO of the company’s fintech division and rebranded it as Like Zero in 2020.
- Virgin Group is another example of management buyouts.
- Energy Future Holdings, Hilton Hotel, Clear Channel, Kinder Morgan, RJR Nabisco, Inc., Freescale Semiconductor, Inc., PetSmart, Inc., and Georgia-Pacific LLC are some of the most famous leveraged buyouts.

Management Buy-Ins (MBI)

A management buy-in (MBI) occurs when a manager or a management team from outside the company raises the necessary finance, buys it, and becomes the company's new management. This type of action can occur when a company appears to be undervalued, poorly managed, or requires succession. The team will be led by a manager with significant experience at the managing director level.

Advantages of Management Buy-Ins

- If the current company owners cannot manage the business effectively, a Management Buy-In (MBI) can benefit both parties.
-

Management Buy-Ins (MBI)

- The incoming management team may bring in new expertise, contacts, and business prospects while re-energizing current employees. Disadvantages of Management Buy-Ins
- If management does decide to buy then they may require additional financial help from a bank or private equity fund. This extra funding introduces additional debt and spreads equity thinner amongst investors.
- Debt repayments can eat into profits and may reduce the money available to pay dividends.
- The new management team may also fail to bring the required growth to the company. Existing employees may not appreciate the new management style and may feel demotivated.

Spin-offs and Sell-offs

A Sell-off A sell-off is a transaction between two independent companies. It occurs when investors sell a large volume of their shares in a short time. If a large number of investors decide to sell their holdings without any compensating increase in buyers, the price of that investment will fall. The divestor may benefit from the cash proceeds, which could be put to more profitable use in the businesses within the group, or used to mitigate financial distress. Sell-off may also add to the divestor by eliminating negative synergy, or by realizing managerial resources preempted by the divested business. It may also sharpen the strategic focus of the remaining businesses & enhance the divestor's competitive strength.

A spin-off. In a spin-off, a company floats off a subsidiary which may be a small part of the parent company. The newly floated company now has an independent existence and is separately valued at the stock market. Shares in the spin-off company are distributed to the shareholders of the parent company. Therefore

Example of a spin off

In the year 1997, PepsiCo spun off KFC, Pizza Hut and Taco Bell into a separate corporation Tricon Global Restaurants Inc. The company spun off 100% of its restaurant unit to stockholders who received shares in the new company. The spin-off was aimed at better focus on its Pepsi beverage operations and Frito Lay snack business. B

Benefits of spin offs

- Enhanced focus
- Reduced organizational complexity & control loss.
- Avoid negative synergy.
- Eliminate the conglomerate discount the parent may have suffered as a diversified company.
- Increase the transparency of both the parent & the spin-off business to the stock market through separate financial reports of the two firms to current shareholders.
- Increase analyst & institutional investor following, create new shareholders & allow to access to new capital.
- Allow shareholders increased flexibility in their portfolio decisions since they now have the freedom to alter the proportion of their portfolios invested in each company.

Disadvantages.

- Divesting divisions may result in the loss of synergies with the core business.
- Tax consequences for both the parent company and shareholders.

De-merger

A business strategy in which a single business is broken into components, either to operate on its own, to be sold, or to be dissolved. A de-merger allows a large company, such as a conglomerate, to split off its various brands to invite or prevent an acquisition, to raise capital by selling off components that are no longer part of the business's core product line, or to create separate legal entities to handle different operations. The act of splitting off a part of an existing company to become a new company, which operates completely separate from the original company. Shareholders of the original company are usually given an equivalent stake of ownership in the new company. A demerger is often done to help each of the segments operate more smoothly, as they can now focus on a more specific task.

Advantages & disadvantages of demergers

Advantages:

- Allows each entity to focus on its core business and strategic priorities.
- Can unlock shareholder value by highlighting the strengths of each separate entity.
- Refocus on their most profitable units
- Reduced risk
- Create greater shareholder value
- Have specialists manage specific business units or brands rather than generalists

Disadvantages:

- Possibility of tax liabilities.
- Require shareholder approval.
- Demergers can be complex and costly to execute.
- Market Reaction: Shareholders may react negatively to the perceived uncertainty and risk

Types of De-Mergers

- **Spinoff**

One of the most common ways for a de-merger to be executed is a spinoff. This step occurs when a parent company receives an equity stake in a new company equal to their loss of equity in the original company. At that point, shares are bought and sold independently, and investors have the option of buying shares of the unit they believe will be the most profitable. A partial de-merger is when the parent company retains a partial stake in a de-merged company. Example: CIPLA and Rwenzori Split A split occurs when multiple businesses are split from the parent company into different entities. If the company is public, shareholders of the parent company are given the option of trading in their shares of the parent company to those of the newly created entity(s).

- **Liquidation De-Merger**

This involves liquidating the business unit in question. Assets are divided among the new companies. It usually happens when there are conflicts between management, board members, and/or shareholders about the direction of the business, allowing new companies to be created so their visions can be met.

Going Private.

This involves converting/purchase of all outstanding shares of a company share that were publicly held into a private company. The transformation of a public company into a private one is called “Going Private”. Once a company goes private, its shareholders are no longer able to trade their shares in the open market. Example: In December 2015, the private equity group JAB Holding Company announced its plans to acquire Keurig Green Mountain. Unlike many private-equity buyouts, this was an allcash offer.

Advantages:

- Reduced Regulatory Burden: Privately owned companies face fewer regulatory requirements and disclosure obligations.
- Flexibility: Privately owned companies can pursue long-term strategies without the pressure of quarterly earnings expectations.

Disadvantages:

- Limited Liquidity: Shareholders may face challenges in selling their shares due to the lack of a public market. ✓ Lack of Transparency: Private companies are not required to disclose financial information, which can impact investor confidence.

How to Predict Corporate Collapse/Failure

Predicting Corporate Collapse can be done through identifying the various signs and indicators such as:

- **Overdue statutory remittance.** Firms that are financially challenged tend to delay remittance deducted at sources such as NSSF, PAYE, and VAT returns. Firms usually try to delay such payments as much as possible to use them in their operations until they can no longer delay them.
- **Issuing post-dated cheques**. These are cheques issued today but cashed at a specified future date. Firms with liquidity problems may issue post-dated cheques, especially to creditors who are demanding their payments and not willing to extend the credit period. The post-dated cheque is taken as a commitment by the firm to the creditor.
- **Cancelled sales/purchase orders**. Distressed firms are at times characterized by the number of orders canceled or subcontracted due to the inability to execute them. In most cases, a distressed firm may win a contract but due to lack of funds to execute them, they are forced to either cancel them or subcontract to a financially stable firm. Firms may also cancel some of their purchase orders in instances where they lack funds.

How to Predict Corporate Collapse/Failure continued

Partial payments on complete deliveries.

Firms that were accustomed to making full payments on completed deliveries but begin to make partial payments upon complete deliveries may be considered to be financially distressed. This is an indicator that a firm does not have sufficient funds to fully settle its obligations.

Records of dishonored cheques. The cashbooks may show records of dishonored cheques as a result of insufficient funds on the firm's account and this is an indication that the firm could not settle its obligations as they matured. Dishonored cheques may however also arise as a result of errors in names, differences in amounts in words and figures, and unmatched signatures. which are not related to financial distress.

Overtrading. This occurs when a firm is operating with a minimal level of capital which is insufficient to support its level of business activities. A firm is considered to be overtrading when it uses more of short-term sources of finance to fund its long-term assets. This is also referred to as undercapitalization and it is likely to put a strain on the liquidity of the firm.

How to Predict Corporate Collapse/Failure continued

Overdue trade credits. This is where a firm takes longer than the required period to pay its creditors, there is a possibility that such a firm is financially constrained and not able to meet its obligations in time. This may also be supported by the firm's effort to renegotiate for an extended repayment period.

Negative net worth. This is when we classify the failure as insolvency bankruptcy. It is a situation where both the book value and the market value of the assets held by the firm can no longer offset its liabilities and the firm is said to have a negative net worth

Therefore, there will be a need to engage financial analysts to perform due diligence to predict failure by using Univariate Analysis or Multiple Discriminant Analysis in quantitative alongside qualitative approaches.

Symptoms of failure

This is the last area of the A-Score model; a business failure may be predicted based on the symptoms being manifested. The model identifies four different symptoms that can be used to predict failure to include; financial ratios, creative accounting, non-financial signs, and terminal signs.

i. **Financial ratios (:** The A-score indicates that worsening financial ratios are a symptom of a failing business. The commonly used ratios to observe include profitability, liquidity, efficiency, and solvency. These ratios collectively give indications of the general performance of the firm; a failing firm is likely to perform poorly in most of those areas.

ii. **Creative accounting :** This is when management begins practicing window dressing while preparing financial statements to portray good performance to intended financial statement users. This may be realized by looking at changes in accounting policies, depreciation policies, asset recognition, etc.

Symptoms of failure continuation

iii. No-financial signs : The model looks at symptoms such as failure to pay management salaries, over time, falling market share, postponing necessary capital expenditures, increasing staff turnover, etc. as predictors of a failing business.

iv. Terminal signs : These are signs that occur when the company is in the advanced stage of failing and it is characterized by a very low level of business activities, inability to meet the basic requirements such as office rentals, closing some administrative units, laying off key staff members, etc. According to the model, an overall score below 25 is preferred and the firm is considered to be safe for the foreseeable future.

Strategies for Company liquidations and Company reconstruction schemes as avenues of addressing corporate failure.

- **Company liquidation** is the process of winding up a company's affairs and distributing its assets to creditors and shareholders. Company reconstruction is a process of the company's reorganization, concerning legal, operational, ownership, and other structures, by revaluing assets and reassessing the liabilities. There are two major strategies to handle company liquidations and company reconstruction schemes and these are distress restructuring and corporate restructuring depending on the nature and severity of the problem, management can either use one or both of the approaches in addressing corporate failure.

Distress restructuring.

It Refers to strategies used by firms to either address corporate failure or revamp a failing business through careful management of debt or financial obligations. The approaches used involve negotiation with the firm's creditors to determine the best way possible to settle the debt obligations in such a way as to allow a firm to continue to operate. The schemes under distress restructuring include extension, composition, subordination, and creditors' control, voluntary and involuntary liquidation. Involuntary liquidation is considered when the creditors are not agreeable to the proposed voluntary settlement schemes.

Voluntary Settlement Schemes.

This is when financially distressed a firm makes arrangements with its creditors outside the legal process to determine a strategy or a combination of strategies best suited to reorganize its operations and clear the creditors' dues. Under these schemes, a firm agrees to a negotiated settlement with its creditors and the two sides evaluate several schemes from which to choose. The schemes commonly used include an extension of the credit period, subordination of claims, creditors' control, composition, and voluntary liquidation.

Extension and subordination schemes

- **Extension scheme**: This involves the firm negotiating with short-term and long-term creditors to postpone the maturity period of the debt obligations hence giving them temporary relief from financial burden. The firms must demonstrate to the creditors that the extended period requested will enable them to generate sufficient cash flows to offset debt obligations.
- **Subordination scheme:** In this scheme, firms negotiate with creditors and convince them to accept claims of inferior quality for their existing superior claims. Firms suffering from financial distress may renegotiate a debt by offering debt for equity. This means that debt holders will become equity holders.

Conditions for extension and subordination schemes

• Assurance of full payments; the firm should be in a position to overcome its financial difficulties during the extension and meet its obligations in full. • Business continuity; the scheme should demonstrate that the firm will be able to survive and continue as a going concern when creditors agree to the schemes.

• Improved Operating efficiency; the firm must show strategies that will be employed to increase cash inflows and reduce cash outflows in the future as well as steps that will be taken to improve operating efficiency.

Voluntary schemes

Creditors control scheme:

This is when creditors take control of the firm's management to improve the firm's performance and financial position until such a time when the firm is capable of paying its creditors. Under this scheme, creditors with business management skills are nominated to steer the firm's operation, and the firm is returned to its owners when all or majority of the creditors have been settled.

Composition scheme: Under this scheme, creditors accept partial settlement of their dues as final payments. The creditors may agree to receive a fraction of their dues as full payment on a pro-rata basis. This is usually acceptable where the liquidation value would be less than the current value due to liquidation cost.

Voluntary liquidation: This is when both creditors and the firm consent to liquidate the assets without going through the court process. When it becomes apparent that the firm is more valuable in liquidation than as a going concern, then informal procedures (performed outside courts of law) can be taken to liquidate the firm's assets. Informal procedures usually yield larger amounts than formal bankruptcy because they avoid legal and related costs of liquidation. Conditions for voluntary settlement schemes include acceptability, business continuity, divestiture, and Management restructuring.

Corporate Restructuring

This approach may be initiated by management in a bid to improve its operating performance and financial position. I. Assets restructuring: Under this scheme, a firm may choose to either expand its operations or terminate some of its operations to improve its financial position and performance. Several options are taken under expansion and these include but are not limited to; mergers, acquisitions, joint ventures, and strategic alliances.

- **Mergers** occur when two or more companies come into agreement to operate as a single unit and therefore give rise to a completely new establishment or legal entity with a new name. The firms may either be in similar or completely different lines of business with the intention of either expanding their market reach, finding new market segments, or gaining market share amongst others.
- **Acquisitions** are when one company acquires either wholly or a controlling stake in another firm's assets. The two firms may either remain independent or merge into one company depending on the terms and percentage of shares acquired. These acquisitions can either be a friendly or a hostile takeover.

Corporate Restructuring continuation

Strategic alliance; this is an arrangement between two or more companies to jointly pursue market strategy while remaining independent entities. Firms may engage in strategic alliance when trying to monopolize a market, capture majority market share, cut operating costs, and penetrate a market. A strategic alliance may be in the form of a joint venture, licensing, franchising, cost-sharing arrangement, and agencies.

- **Joint venture** involves the pooling of resources from two or more firms with a common interest to venture into a project whose returns would be shared according to their capital contribution.
- **Franchising** refers to the granting of rights by one firm to another to operate in a specific business location using its brand name, and trademark and distribute its products without changing the quality.

The rationale for asset restructuring includes value maximization through the synergy effect, risk diversification, competitive advantage, resource mobilization, market positioning, and divestiture.

II. Management and operational restructuring a distressed firm may also choose to make changes in its management and operational structure to address the problem. This may be done in various ways including downsizing, changing management, or business location.

Corporate Restructuring continuation

III. **Ownership restructuring** refers to when a firm is not performing to its expectation and the problem is perceived to arise from ownership, then, ownership restructuring becomes e most effective approach to revamp performance. The intention is to improve the performance of such a firm and to avert the threat posed by a distressed situation. The restructuring may be affected by undertaking one or a combination of the following strategies; i) Selling the company to another investor. ii) Share repurchase. iii) Security exchange offers. iv) Going private. v) Management buy-out.

Involuntary Settlement - Forced Liquidation

This occurs when a firm is forced to sell off its assets or wind up its operation by creditors through the courts of law to salvage what the firm owes them. This can however happen only when creditors are not agreeable to the voluntary schemes presented by management.

END OF SESSION EIGHT