Valuation and Corporate M&A

Interview preparation summary · FP track

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INT.FT.1.a · Valuation for the corporate

Move between enterprise value and equity value, and apply a consistent trading multiple to value a company or a target.

Enterprise value is the value of a company's operating business to everyone who funds it, while equity value is what remains for shareholders once the claims ranking ahead of them are settled. The bridge from one to the other deducts borrowings, lease liabilities (where the earnings measure adds lease costs back), pension deficits and minority interests, and adds cash and the value of associates. Multiples follow the same logic: EV to EBITDA or EV to sales pairs an enterprise value with a figure struck before interest, while price to earnings pairs equity value with earnings after interest. Mixing them, for example applying an EV multiple to net income, is the commonest error. Interviewers ask this because corporate teams value targets, divisions and their own company this way. A good answer chooses the multiple that fits the question, takes peers on a like-for-like basis (same accounting treatment, similar growth and risk), builds the bridge in full, uses diluted shares and gives a range rather than a single point.

WORKED EXAMPLE: MARLOW FOODS: FROM A PEER MULTIPLE TO A SHARE PRICE

Marlow Foods is an invented packaged-food group with EBITDA of 40.0m, struck after adding back lease costs. Comparable companies trade at about 8.0 times EV to EBITDA on the same basis. Marlow has borrowings of 90m, cash of 20m, lease liabilities of 15m, a pension deficit of 10m and minority interests of 5m, and it owns an associate worth 8m. There are 76m diluted shares. Estimate the value per share.

Answer: About 3.00 per share at 8.0 times, with a range of roughly 2.5 to 3.5 per share across 7.0 to 9.0 times.

> **Interview tip:** Say the order out loud: multiple on the right metric gives enterprise value, then I deduct every claim ahead of shareholders and add what EBITDA does not capture, then divide by diluted shares, and I give a range because the multiple is a judgement.

INT.FT.1.b · Valuation for the corporate

Build a simple discounted cash flow valuation, including a terminal value, and explain how far to trust it.

A discounted cash flow values the business as the present value of the free cash flow it is expected to generate for all capital providers. Unlevered free cash flow is operating profit after tax, plus depreciation, less capex and the increase in working capital, with no interest deducted. Cash flows for an explicit forecast period, often five years, are discounted at the weighted average cost of capital, and a terminal value captures everything afterwards, commonly by growing the final year's cash flow at a long-run rate (growth perpetuity) or by applying an exit multiple. The result is an enterprise value, so net debt is deducted to reach equity value. Interviewers ask this to see whether you know the mechanics and the weakness: terminal value often supplies well over half of the total, and a small change in the discount rate or growth rate moves the answer a lot. A strong answer shows the sensitivity, cross-checks the implied exit multiple against peers and says what would change the view.

WORKED EXAMPLE: CALDER COMPONENTS: A FIVE-YEAR DCF

Calder Components is an invented engineering firm. Forecast unlevered free cash flow is 12m, 13m, 14m, 15m and 16m at the end of years 1 to 5. The discount rate is 9% and cash flows after year 5 are assumed to grow at 2% a year for ever. Net debt is 45m. Estimate the enterprise value and the equity value, and say how much of the value is terminal value.

Answer: Enterprise value is about 205m and equity value about 160m, with 74% of the value in the terminal value.

> **Interview tip:** Give the answer, then the caveat in the same breath: it is about 205m, but three quarters of that is terminal value, so I would show how it moves with the discount rate and growth rate and check the implied exit multiple against peers.

INT.FT.1.c · Valuation for the corporate

Value a division or project at a rate that reflects its own risk, and build a sum-of-the-parts valuation for a group.

A group is a portfolio of businesses with different risk, growth and capital needs, so a single group discount rate or multiple can mislead. To value a division, discount its cash flows at a rate that reflects the risk of that business, often estimated from listed pure-play peers, and not at the group's blended cost of capital. Using the group rate flatters risky divisions and penalises safe ones. A sum-of-the-parts valuation values each division separately, usually with the multiple of its own peer set, subtracts the capitalised cost of the central functions that no division carries, then deducts group net debt and other claims to reach equity value. Comparing the result with the market capitalisation shows any conglomerate discount. Interviewers ask this because corporate teams decide whether to keep, sell, demerge or invest in each division. A good answer names the right comparables, remembers central costs and tax leakage on a sale, and treats a gap to market value as a question to explain, not as proof that the shares are cheap.

WORKED EXAMPLE: ASHDOWN GROUP: TWO DIVISIONS AND A GAP TO THE SHARE PRICE

Ashdown Group is an invented group with two divisions. Packaging has EBITDA of 24m and comparable companies trade at 7.0 times. Labels has EBITDA of 12m and comparables trade at 9.0 times. Central costs of 5m a year are valued at 8.0 times. Group net debt is 80m and the market capitalisation is 130m. Separately, Labels is expected to produce free cash flow of 9.0m next year, growing at 2% for ever. Find the sum-of-the-parts equity value and the discount to it. Then value Labels on its own with a rate of 10%, compared with a group rate of 8%.

Answer: Sum-of-the-parts equity value is 156m, about 17% above the market value of 130m, and Labels is worth 112.5m at its own 10% rate, not 150m at the group's 8%.

> **Interview tip:** Give the figure, then say what you would check before believing the gap: whether the peer multiples really fit each division, whether central costs and tax on a sale are fully reflected, and why the market may be applying a discount.

INT.FT.2.a · Corporate development

Assess the rationale for an acquisition and value its synergies against the premium paid.

A corporate buyer should be able to say why it is the best owner of a business, and the usual reasons are cost savings, revenue gains, capability or access to a market, and sometimes a lower cost of capital. Cost synergies, such as removing duplicated overheads, combining purchasing or closing a site, are typically more reliable than revenue synergies, such as cross-selling, which depend on customers behaving as hoped. To value them, take the run-rate saving after tax, capitalise it at a suitable discount rate (or discount a phased schedule), and deduct the one-off costs of achieving it. That net present value is the most a buyer can pay above the target's standalone value before its own shareholders lose. A premium larger than the net synergy value hands all the gain, and more, to the seller. Interviewers look for this discipline and for a haircut on soft synergies. Diversification alone is a weak rationale because shareholders can diversify themselves more cheaply. Strategic fit, integration risk and who captures the value are the points to cover.

WORKED EXAMPLE: BRIGHTWELL PACKAGING BIDS FOR OAKMOOR LABELS

Brightwell Packaging, an invented manufacturer, is considering buying Oakmoor Labels, whose market capitalisation is 240m. The board expects to pay a premium of 25%. Run-rate cost synergies are 8.0m a year before tax, one-off integration costs are 10m before tax, the tax rate is 25% and the discount rate for synergies is 10%. Revenue synergies are excluded. Value the synergies and say whether the premium is covered.

Answer: Net synergies are worth about 52.5m against a 60m premium, so a 25% premium is not covered; the ceiling is a premium of about 22%.

> **Interview tip:** Say that the premium is a transfer to the seller and the synergies are the buyer's only source of gain, then give the net figure and the ceiling, and add that a phased schedule and haircuts to soft synergies would lower it further.

INT.FT.2.b · Corporate development

Work out whether an acquisition is accretive or dilutive to earnings per share under cash, debt and share funding, and explain why that is not the same as creating value.

Accretion or dilution compares the buyer's earnings per share after the deal with its earnings per share before. The pro forma earnings are the buyer's net income plus the target's net income (plus any synergies) less the after-tax interest on new debt or the income lost on cash used, divided by the old shares plus any new shares issued at the buyer's share price. A quick test: a debt-funded deal is accretive when the target's earnings yield (net income divided by price paid) exceeds the after-tax cost of the debt, and a share-funded deal is accretive when the buyer's P/E is higher than the P/E paid for the target. Interviewers ask

this because boards watch EPS, and because the test is quick to do aloud. The trap is treating accretion as proof of value. A deal can raise EPS yet earn less than the cost of capital, and cheap debt flatters the answer while adding risk. A strong answer does the arithmetic, states the funding assumptions and then compares the return on the price paid with the cost of capital.

WORKED EXAMPLE: HOLLIS PLC BUYS TARN SENSORS

Hollis plc, an invented industrial group, has net income of 120m and 200m shares, so EPS is 0.60, and its shares trade at 9.00. It will pay 540m for Tarn Sensors, which earns 30m. Compare funding the whole price with new debt at 6% before tax (tax rate 25%) against issuing shares at 9.00. Ignore synergies and fees.

Answer: Debt funding is about 4.8% accretive and share funding is about 3.8% dilutive, but accretion alone does not show that value is created.

> **Interview tip:** Give both results, then the reason in one sentence: debt wins because Tarn's earnings yield beats the after-tax cost of debt, and I would add that the board should also ask whether 30m of earnings earns more than the cost of capital on 540m.

INT.FT.2.c · Corporate development

Explain how a corporate team handles disposals, integration costs and due diligence, and how its role differs from an adviser's.

Corporate development sits inside one company and works for one owner over many years, whereas an adviser at a bank works across many clients, is paid largely for completed transactions and leaves once the deal is done. The corporate team owns the strategy, the valuation, the negotiation, and the integration afterwards, so it lives with its own forecasts. In a disposal the question is whether the price beats the value of keeping the business, after tax on the gain, transaction costs and stranded costs that stay behind when the division leaves. The effect on EPS matters less than that comparison. Integration budgets typically include severance, systems migration, retention payments, duplicated running costs and rebranding, and are often underestimated. Due diligence tests the numbers behind the price: quality of earnings, one-off items, debt-like items such as pension deficits and deferred payments, working capital against a normal level, customer concentration and contracts. Findings move the price, the structure (earn-outs, indemnities, conditions) or the decision to proceed.

WORKED EXAMPLE: PENNINE GROUP CONSIDERS SELLING ITS FIXINGS DIVISION

Pennine Group, an invented industrial group, is offered 52m for its Fixings division. Keeping the division is worth 46m on a discounted cash flow basis. The division's tax base is 30m, selling costs are 1.5m and tax on the gain is 25%. Head office costs of 1.0m a year before tax stay behind and cannot be removed. Use a 9% discount rate and treat the stranded costs as a perpetuity. Should Pennine sell at this price?

Answer: At 52m the sale is worth about 37.0m after tax, costs and stranded costs, against 46m for keeping, so do not sell at this price.

> **Interview tip:** Say that the headline price is not the comparison: it is net proceeds less stranded costs against the value of keeping the division, and then say what you would do about the stranded costs and the price.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.