



GROUP WORK ASSIGNMENT

GESTÃO FINANCEIRA II

UNDERGRADUATE PROGRAMS

2nd SEMESTER 2012-2013

The Group Work Assignment of Gestão Financeira II involves solving a practical corporate investment project case. This requires a sound knowledge of cash flow forecasting, determining cost of debt and cost of equity in different industries, making credible assumptions about different scenarios, and decision-making.

The case-study is briefly summarized in the next page, but please read first the rules of the game.

Rules of the Game:

1. Important Dates:

Group Composition by April 12th, 2013: Each group must give to one of the course instructors a sheet of paper containing – for each member of the group: name, student number, photograph, and class (turma) attended.

Final Due Date is May 20th, 2013: you can hand in your assignments to your class instructor (during any class before the deadline) or address it to Professor Clara Raposo (Gabinete 616) – at the reception of the ISEG building in Rua Miguel Lupi, No. 20;

2. Each group must be of 4 to 5 students. If any of you has a problem in finding partners, let your class instructor know as soon as possible, and a solution will be found.

3. The assignment involves producing three elements:

A printed **Report** written in Microsoft Office **word**, discussing your choice of methodology, assumptions, computations, tables, and conclusions (MAXIMUM 10 pages A4);

A **Spreadsheet** in Microsoft Office **excel** in a cd-rom, supporting your written report;

A **Presentation** in Microsoft Office **powerpoint** included in the cd-room.

4. Any group and group member may be asked by the course instructors to **present** their assignment.

CASE DESCRIPTION:

PLAYING THE FIELD: A NEW DIMENSION IN CRIME



“My name is Grass, Grass Hopper, the fiercest criminal mind ever. Join me and we’ll rule the world...”

DISCLAIMER: Most numbers provided regarding investment and quantities are totally fictional!!!

Electronic Arts Inc. was founded in 1982 and is publicly listed in Nasdaq. Its global headquarters are in Redwood City, California, and it employs 9,000 worldwide (as of March 31, 2012). Electronic Arts Inc. is a leading global interactive entertainment software company. EA develops, publishes, and distributes interactive software worldwide for Internet-connected consoles, personal computers, mobile phones, tablets and social networks. In fiscal 2012, EA posted GAAP net revenue of \$4.1 billion. EA is recognized for critically acclaimed, high-quality blockbuster franchises such as The Sims™, Madden NFL, FIFA Soccer, Need for Speed™, Battlefield™, and Mass Effect™.

On March 18th, 2013 EA’s Chief Executive Officer John Riccitiello announced that he is stepping down as CEO and from the Board of Directors by the end of this month. In a letter to employees, Riccitiello attributed his departure to EA’s financial results. Riccietello said in the press release announcing his departure:

“EA is an outstanding company with creative and talented employees, and it has been an honor to serve as the Company’s CEO. I am proud of what we have accomplished together, and after six years I feel it is the right time for me to pass the baton and let new leadership take the Company into its next phase of innovation and growth. I remain very optimistic about EA’s future — there is a world class team driving the Company’s transition to the next generation of game consoles.”

The fictional component of the assignment comes next.

The new executive team that will take over the management of this company has a big challenge ahead – find the perfect new game, the one that catches everyone’s eye and takes you to a new limit.

You and your team are currently working on the final stages of development of a new game-concept: Can you imagine the worst criminal mind ever? A mind capable of anything? That’s our “anti-hero”, Mr. Grass Hopper, the most corrupt, unscrupulous, character ever. The rationale of this game is making you hate your hero, but wanting to play the game and see how far you can take him. The first release of the game will consider the world of drugs – all types, and many levels of difficulty, in which your scruples will be tested like you never imagined they could be. But sequels are expected: Mr. Grass in the world of financial crime, Mr. Grass King of Weapons, Mr. Grass poisons the world, etc, etc... We leave this to your imagination.

The development of this new game will require an immediate investment in R&D of \$80 million and of \$40 million in capital expenditures (in equipment with a life of 10 years).

This game should increase total revenues of the company by 20% at the end of this year, when it is released, and drop steadily after that. The gross profit margin for this project should be similar to what it currently is for EA as a company overall. Every 2 years we expect to launch a new release version of the game, and revenues are expected to be even higher than for the previous versions. As time passes, older versions tend to lose market share. For how many years will Mr. Grass Hopper be around? That is going to be your choice. Be serious in motivating your projections of growth rates, etc.

Selling, general and administrative expenses are about 20% of the annual revenues. Annual Net working capital will be your choice. Explain your choices.

As a newly hired expert in the capital budgeting division you have been asked to evaluate the new project. You will compute the appropriate cash flows, costs of capital and the net present value. You must seek out the information necessary to value the free cash flows. But you’ll be given some directions to follow!

Additional Help on How to Get More Information:

Data on Electronic Arts Inc. (quote EA) is available at Yahoo Finance (<http://finance.yahoo.com>):

- Go to Yahoo Finance (<http://finance.yahoo.com>) and get the quote for Electronic Arts Inc. (symbol: EA). If you click “Key Statistics”, in the bottom of the page you will find “View Financials”. You can then choose to view “Income Statements”, “Balance Sheet” or “Cash Flow”, for the last 3 years (select Annual Data).
- For the cost of debt (r_D) you can go to NasdBondInfo.com, (<http://cxa.marketwatch.com/finra/BondCenter/Default.aspx>), and click to search by symbol. Enter the symbol EA, which is the ticker for Electronic Arts Inc. After entering EA’s symbol, you select the “Corporate” toggle, and press “Enter.” You should have access to EA’s average **credit rating** for long-term bonds. If the company has no bonds rated, you probably can check whether its debt is “small”. If so its cost should be reasonably low. There is information about this on pages 80 and 95 of the Annual Report of 2012 (corporate website).
- For the cost of equity (r_E) you can get **the yield on U.S. Treasury Bonds** from Yahoo! Finance (<http://finance.yahoo.com>). If you scroll down to the Market Data, on the right hand side you select “Bonds” and then you have information on the Yield to maturity. Enter that yield as the risk-free rate.
To find the **beta** for EA Inc. use (<http://www.nasdaq.com/symbol/mcd>), where EA is the ticker for EA Inc. (Sometimes you must be patient.)
- Use a **market risk premium** of 4.00%.
- To compute the **net debt** for EA, add the long-term debt and the short-term debt and subtract cash and cash equivalents for each year on the balance sheet.
- To compute EA’s **market capitalization** at the end of each fiscal year multiply the historical stock prices by the “Basic Weighted Shares Outstanding” data in the income statement. Or you can go to <http://www.marketwatch.com/investing/stock/> enter EA’s symbol, and choose Historical Quotes (on top). You can check prices for any date you want.
- You may also get information on **industry** betas from <http://pages.stern.nyu.edu/~adamodar/> by selecting Updated Data/ Levered and Unlevered Betas by Industry.
- You are also advised to visit Electronic Art’s site and its annual reports.

QUESTIONS

1. Estimate the FCFs of the project. Explain carefully your assumptions.
2. Assume that the project is financed exclusively with equity (unlevered). Is this new investment valuable? Explain your answer.
3. Perform reasonable sensitivity and /or scenario analysis. Explain.
4. Now assume that the project uses a target capital structure, which is equal to the firm's average capital structure of the last 3 years. Compute the WACC rate, and re-evaluate the project. Comment.
5. Now imagine that the cash flows of this project were actually related to another project that the company wants to start in a totally different industry – the restaurant business – to be financed with a target debt-to-equity ratio of 1.3. What would the NPV be in this case?