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Chemaco: A target for a takeover?[1]

The share price of Chemaco before the crisis was around €15. However the economic crisis has devalued most of European quoted companies. Chemaco share price has been since then below €10 and it has been difficult to recover. Rating agencies continue to classify the bonds of the company as junk. However the company has always had profits in this period with good level of return on invested capital and low level of debt. In spite of its recent announcement of an increase in the profit of 2014 by 25%, the market did not react at all. In contrast, the shares of other European companies in the same sector have been recovering steadily. Chemaco was founded more than one hundred years ago as a chemical company, but now this business represents approximately one third of the sales. The other two thirds of sales come from food and beverage businesses. Apparently the market continues to view the company as a chemical company. The president of Chemaco was concerned with such low share prices and the difficulty of the stock market to recover. This level of share price was making the company attractive for a takeover. This was reported a week ago by the financial press, mentioning that one of the largest shareholders of the company considered the company undervalued. There were also rumors that the president was meeting several investment banks to analyze potential financing to support a MBO. As they are short of cash, the rumors said they aim to control 15% to 20% of the equity. The target price by financial analysts is in the range of €10 to €12.

A business professor and consultant of the firm has advised splitting the company's business – chemical on one side and food & beverages on the other. His argument is that doing so, the financial market could evaluate each of the businesses properly and is also a way to create value for shareholders. However the president of the company didn’t agree with the idea.

Considering the shares were undervalued, the Board of Directors announced by mid last year an acquisition plan of 2 million Euros of own shares with prices ranging from €10 to €12. In the following month the company acquired over 2 million shares with an average price of €11.50.

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[1] João Carvalho das Neves, Professor, ISEG School of Economics and Management, Lisbon University, 2015. This is a made-up case written for academic purpose, only.

Despite having spent about 23 million Euros, the share price of Chemaco remained at the level of €10 in spite of its profits and sales continued to grow.

More recently, the Shareholders General Meeting approved the Board of Directors proposal to introduce anti-takeovers and golden parachutes clauses in the company articles of association. This decision was not welcomed by the market as it was a clear sign of the Board of Directors fearing a potential takeover bid.

In spite of the President being very active in trying to develop joint ventures with competitors all joint ventures hypotheses ended up not materialized.

As a consequence of all these trials and the low level of the share price, the idea of a LMBO gained strength among the members of the Board of Directors. At the moment of the acquisition the leverage would be high however the assets strength of the company would allow developing a plan to deleverage the company. Among those measures were:

- Spinning-off of chemical division;
- Selling the new headquarters and return to the previous building the company was not able to sell. In fact, this new headquarters is clearly an unnecessary excess. A prestigious academic in the area of corporate finance in the inauguration day classified it as an example of agency theory of this company.
- Abandonment of those research projects that were still requiring high volume of investment and with lower probability of success.

Some analysts have commented they don't see the LMBO as a good solution for the company for two main reasons:

- The financial strength of a company is its capital base. The replacements of shareholders by bank loans generate unnecessary additional financial risk.
- The role of management is to create value for shareholders, using innovation creativity in the development of new products with strict control over costs. Financial engineering should be used to create value for shareholders, not to be used in the interest of the management team.

The Board of Directors has contracted recently two consultants – an economist and a lawyer - specialized in LBO and MBO. They both have helped the Board to deepen the pros and cons of such a deal. They discussed for hours issues concerning the business, cash flows, market share per product, sales and profits. The president wanted to know the value of each business in his hands and in the case of a takeover.

As a consequence of this analysis two banks were invited to participate in LMBO.

The company was ideal for an LBO. It was considered undervalued and the historical data evidences a continuing increase in sales, steadily growing of operational cash flows and low level of debt. The share price continues below €10 with debt equal to 1,300 million EUR, that is a multiple of Debt to EBITDA of 3.3.

In the meantime, a well-known raider was also considering a takeover. He has been in conversation with a small boutique investment bank that is undoubtedly the brightest in takeovers. The raider considered more important to have this boutique on his side than against him. It could be dangerous if they took the side of president of the company in his MBO.

In mid may, the Board of Directors decides to announce the MBO offering €10.5 per share.

The various assessments in raider possession were all valuing the company by more than €12 per share. All financial analysts were convinced the company had plenty to lose weight, but did not expect such high valuations.

Table 1 – Last Year Key Financial Data

	(Million EUR)
Major balance sheet items	**2014**
Fixed assets	1.375
Working capital requirements	440
Cash and equivalents	150
Total	1.965
	(Million EUR)
Major income items	**2014**
Sales	2.200
EBITDA	396
Depreciations	83
Operational income	314
Income taxes	78
Net operational profit after taxes	**235**

The raider assumptions for valuing Chemaco are in the following table:

Table 2 - Financial assumptions

ASSUMPTIONS	2014	2015	2016	2017	2018	2019
Annual growth rate		5%	4%	3%	3%	1%
Average growth terminal value						3,0%
EBITDA margin ratio	18%	20%	22%	22%	22%	22%
Income tax	25,0%					
Fixed assets turnover	1,60	2,00	2,00	2,00	2,00	2,00
Depreciation to fixed assets	6,0%	6,0%	6,0%	6,0%	6,0%	6,0%
WCR to sales	20%	18%	18%	18%	18%	18%
Divestments (million EUR)		145	80	0	0	0

The unlevered rate of return required by the raider is 12%. He admits that the level of indebtedness for the terminal value is 25%. The payment period of the debt is assumed to be 6 years, with a constant annual debt service and interest rate on loans 6%.

If you were the consultant of the raider, based on the data available, what would be your advice concerning the takeover?