Workshop 2 Session 7

Pre-workshop exercise 5 (Corporate Finance)

The board of GMHK have been considering whether to make an offer to purchase **Lucky Lion Handsets**, the handset producer in Guangdong province. Although it is a medium-sized producer of handsets, it is bigger than **Tiger Handsets** in terms of production capacity and sales volume. By acquiring Lucky Lion, GMHK would be able to produce handsets initially for other mobile phone operators in the China Golden Monkey Mobile group and eventually for external mobile phone operators too. This should offer substantial opportunities for long-term growth within the communications industry.

There is some **disagreement** amongst the board members about whether Lucky Lion Handsets can be acquired for a suitable price. Lucky Lion is not a listed company, but the shares of similar listed handset producers and OEMs trade on HKSE at a fairly high price relative to earnings. The P E ratios of these similar companies are shown in the table below.

Company	P E ratio
1 Giant Giraffe Limited (GGL)	21.5
2 Hungry Hippopotamus Limited (HHL)	25.0
3 Zippy Zebra Limited (ZZL)	18.6

It has been an element in the capital expenditure policy of GMHK that all capital expenditure projects should pay back within seven years on a non-discounted basis, and a majority of board members see no reason to change this policy for the proposed acquisition of Lucky Lion.

GMHK has expressed its interest in acquiring Lucky Lion, and in response its owners have provided some indicative financial information about the company's expected profits in the current year, as follows.

	HK$m
Revenue	600
Cost of sales	(330)
Gross profit	**270**
Distribution costs	(120)
Administrative expenses	(110)
Net interest expense	(1)
Profit before tax	**39**
Taxation	(7)
Profit after tax	**32**

Lucky Lion has long-term borrowings of HK$ 100 million, and substantial cash and bank deposits. However the owners of the company have stated that if they agree to sell the company, they will withdraw all the cash in a special dividend payment before the sale occurs.

GMHK has estimated that if capital expenditure by Lucky Lion Handsets remains at about HK$ 60 million each year, which is equal to the annual charge for depreciation and amortisation, the company would be able to achieve growth of about 5% per year in sales and earnings for the foreseeable future.

At an initial board meeting of GMHK to discuss the possible acquisition of Lucky Lion Handsets, it is agreed that a suitable offer price that might be acceptable to the owners of the target company would have to be based on a PE ratio multiple. However, the board would also expect payback within seven years of making the acquisition.

Required

(a) **Suggest with reasons an offer price, based on a P E valuation, that might be acceptable to the owners of Lucky Lion.**

(b) **Suggest with reasons whether an acquisition at this price would pay back within seven years, and indicate the annual rate of growth in annual cash flows that might be needed for the investment to pay back within seven years.**

(c) **Recommend what the board of GMHK should do next, before deciding whether to make an offer for 100% of the equity shares of Lucky Lion Handsets.**