2.6.3 Valuation of Yule Catto Exercise

Unit: Unit 1 – Treasury Strategy

Module: Module 2 – Valuation

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Summary: A valuation of Yule Catto as at the end of 2010 [1]

Keywords: valuation, beta, risk free rate, market premium, cost of equity, cost of debt, gearing, capital structure, WACC, tax, enterprise value, equity, market capitalisation, minority interests, pension deficits, sustainable cash flow, EV/sales, EV/EBITDA, price to earnings ratio, multiples, growth rate

Question 1

Value Yule Catto's equity using the un-geared valuation method, and assuming stable gearing as at the end of 2010 using the accompanying 2010 annual report as your main source of data. Ignore the impact of the PolymerLatex acquisition which was announced on 14 December 14 2010 when attempting to undertake the valuation.

Data available

- Annual reports for 2010
- Morgan Stanley report on Yule Catto dated 14 March 2011

Use the following assumptions in your analysis:

a)	Beta	1.1
b)	Risk Free Rate	6.0%
c)	Market Premium	3.0%

You should compare your valuation to the share price for Yule Catto. Note that this was very volatile around the 2010 year end as shown below. How does your estimate compare? Can you explain any variation? Consider using different growth assumptions.

[1] We restrict our analysis to the end of 2010 because Yule Catto announced a major acquisition in December 2010 and following this, it is difficult to establish trends.

The PolymerLatex acquisition was announced on December 14, 2010 and resulted in a 30p rise on the day to close at 287.4p

A spreadsheet of the most important data has been partly completed for you (see accompanying exercise spreadsheet). This has been compiled mostly from the 2010 accounts and the 5 year summary on page 83 of the report. We have already made some calculations, suggestions and estimates to help you.

Financial data tab

We have looked at data for 5 years which is probably more than strictly necessary.

With regard to the P&L data, we have tabulated 3 sources:

1. Using the consolidated P&L statements – but excluding *Special Items* which are regarded as exceptional.
2. Using the "Underlying Performance" data from the 5 year summary. We expected this to be the same as that above, but this is only true for the latest 3 years.
3. Using the IFRS data from the 5 year summary. This includes data for discontinued activities and in our opinion is the least useful. Oddly EBITDA is the same in this dataset, even though operating profits are considerably different.

Share price data

Sourced from http://shareprices.com. Note that the data either side of the 2010 year end appears to conflict with that used in the chart provided in the question.

WACC tab

It is important when calculating WACC to use market values for equity and debt. We have calculated the market value of equity at the year end and suggested appropriate values for debt.

The market value of equity is relatively straightforward to determine, although we need to be cognisant of the 2010 year end volatility.
For borrowings, we could use the year end figure, but this can be misleading in valuation terms as it may not be representative of average borrowings throughout the year. As a result the Enterprise Value (EV) could be significantly miss-stated. However, in the case of Yule Catto, there is clearly an emphasis on reducing borrowings, so we have used the year end data. Again, we cite the 2010 Financial Review on page 12 of the Annual Report which states, "Underlying net debt reduced significantly during the year."

We have also adjusted the net borrowings figure in the light of the fair value data in Note 21 with regard to the Loan Notes and the US$ swaps (Note 30). These appear to be the items affecting borrowings as far as we can determine from the data. The data for derivatives at fair value in the balance sheet presumably includes foreign exchange contracts for transaction exposures which we do not need to adjust for.

We also have to decide if we need to reflect cash in Yule Catto's WACC. The analysis shows that Yule Catto earns substantial interest income, although this is much lower in 2009 and 2010 than previously. Between 2007 and 2009 Yule Catto disclosed its underlying cash position at the year end (which was overstated in the accounts due to cash pooling). Significantly no adjustment was required in 2009, so perhaps this is no longer an issue.

Yule Catto state in Note 21 that their Effective Interest Rate for 2010 was 4.8%. Using the interest paid data, this implies an average loan balance of £172m in 2010 compared to £149m in 2009 using the same method. Once again, this contradicts the clear statement on page 12 of the Financial Review which states, "Underlying net debt reduced significantly during the year." It seems more probable that the 4.8% figure is questionable, so we have used the 6.6% implied by the year end borrowing balances which seems consistent with earlier years.

Question 2
Compare your results to those in the Morgan Stanley Broker Report as at March 14, 2011. This contains a DCF valuation on page 7.

Question 3
Calculate the following financial ratios for Yule Catto at the 2010 year end:

1) EV to Sales
2) EV to EBITDA
3) P/E ratio

Comment on these in the light of the sector multiples in Exhibit 10 on page 6 of Morgan Stanley's report.