

Case Atlas Corporation

Atlas is an engineering company which was founded 30 years ago by the current CEO, Derek Rhys.

The company showed profits for most of the years, but in the year 2017 the company tried to scale up with debt heavily increasing their operations in the export markets. The situation had a negative development due to the wrong strategic approach and a lack of control by the company managers. As a result, from this experience and after a very slow recovery, Rhys is now much more risk averse, and therefore he is trying to avoid debt as much as possible. Currently the company has a 0 debt.

The CEO now has a new project, this is a new venture within AI and the digital twin business, and he believes this could be a very profitable business. The required investment for this project is of 70M€, and the expectations for profitability show annual pretax earnings of 10M€ in perpetuity.

Now the company, or Rhys, must decide whether to finance with debt or equity. Even though he dislikes debt, he hired a strong CFO lately who believes that debt would be adding value to shareholders. According to the first estimates based on Peter Franciscus research (Peter is the “new” CFO), the best deal they could find is a 50% debt investment, this means that the company should rise half of the investment in new shares and 50% with Bonds. An increased level of debt would make the company more vulnerable and therefore the financing costs would sharply increase up to an undesirable level.

The bonds would be issued at par value with 6% annual coupon payments.

Atlas’ income tax rate is 25% currently.

The company has a market capitalization of 350M€, and 7M shares outstanding.

The company cost of equity is 10%.

The CEO is not only very risk averse, but he is also a man who does not trust anybody, and feels very stressed by this situation, his wife has convinced him to talk to you, as even though you are still studying, she feels you are a brilliant student, and she fully trust you, so Rhys has asked you for advice. If he is satisfied with the advice, you will have a good opportunity to find your first paid job after you finish your studies.

1. Rhys wants to know if he should issue debt or equity for this investment and why.
2. As Atlas is a public company, he would like to know which is the market value balance sheet before the investment in the new project is announced.
3. If the CEO decides to make the investment 100% with Equity, what would be the Net Present Value of the project?
4. What would be the market value balance sheet after the company announces the project fully financed by Equity? How many shares will have to be issued to finance the project? What would be the price per share?
5. Construct the market value balance sheet after the equity issue and before announcing the new investment project. How many shares outstanding has the company? How much is the price per share?
6. Construct the market value Balance Sheet after the new investment has been made.
7. What will be the market value of the company if they finally decide to issue debt?
8. Prepare a balance sheet at market value after the debt is issued and the investment is done, what will be the value per share now?
9. Which of the alternatives do you think would be better for Rhys, as he is the majority shareholder?