FGA CASE STUDY

If you wish to ask questions (and get answers from the author of this case study), please do not hesitate to use the mail box of the web site www.vernimmen.net

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The French group FGA is ranked 7th in the European insurance industry and well established in France, Benelux and Spain. It should have in 2011 a turnover of € 11 bn, and a net profit of € 0,3 bn. Its market capitalization is of € 4,8 bn, and shareholding is dispersed.

The British group JV is number 2 in the European insurance industry. It should have in 2011 a turnover of € 24 bn and a net profit of € 1,2 bn. It is traded on the stock market, and its market capitalization is of € 30 bn. Shareholding is dispersed.

Lastly, the Italian group Marechali is number 3 in the European insurance sector, and it should have a turnover of € 15 bn and a net profit of € 0,45 bn in 2011. Its market capitalization is of € 21 bn and it is controlled by some Italian families.

End 2010, Marechali that recently had its CEO replaced decides to become more international and launches an hostile bid on FGA, offering 45 euros cash for shares that traded at 36 Euros. Caught unaware, FGA management feels it is attacked and qualifies the operation as hostile. It then scouts with the help of its banking advisors for a partner that would help it to turn down the Marechali proposal.

That is when JV enters the picture.

JV immediately sees the opportunity to regain its first place in the European insurance sector that it recently lost and the possibility to enter the France and Benelux markets where it is not very active. Then, as the negotiations between FGA and Marechali do not go anywhere, JV understands it can take control of FGA, its management being ready to accept it in order not to fall under the grips of Marechali.

A financial committee at JV is held with the main directors, the management and the advisors to JV in order to judge the financial aspects of the proposed acquisition of FGA.

Here are some excerpts :

“**CEO**: Our meeting of yesterday was about the strategic aspects of ours taking control of FGA et we concluded that it was a once in a lifetime opportunity to reinforce our position on the French market and that at this time we did not have any investment opportunities more interesting than that one. Our CFO is going to present us with the financial aspects of that operation. Jack, this is your turn to speak.

CFO: Like we are used to and with the help of our banking advisor, we applied to the acquisition of FGA the usual financial criteria for our group. You will find them in exhibit 2, showing two financing alternatives: either 100% equity, or 100% debt.

We calculated the NPV (net present value) of our investment in buying FGA with :

-a price paid of 48 Euros per FGA share, reflecting the level at which our banking advisor thinks the market will accept our offer.
- forecast for the future cash flows coming from FGA, taking into account the synergies we expect between JV and FGA.

As we are investing in a French company, we did not apply our WACC (weighted average cost of capital) of 9%, but the WACC that applies to France (7.6%), the spread coming from the difference in the risk free rate in the UK (4.6%) and that in France (3.2%), as the β coefficient is the same (0.8) for FGA and JV, as is the risk premium (5.5%). In that case, the NPV (Net Present Value) of that investment is positive by € 0.6 bn and ...

First director: ... Whoa ! not so fast. You use that rate only to justify that investment. But if you used our rate of 9%, the NPV would have been negative by € 0.45 bn, as shown in exhibit 1, and in that case, the investment is of no interest from a financial point of view. After all, this is our British shareholder or our British bankers who are going to finance that acquisition, and there are no motives for them to want less (7.6% instead of 9%) only because we are going to invest in France and not in the UK.

CFO: And if we had made an investment in Russia or Pakistan, you would of course have used that same rate of 9% ! ...

Second director: But Marechali is going to use a lower discount rate than ours, since its WACC (7%) is lower than ours (9%). If they take into account the same synergies as we did, they will outbid us and we have no hope to win. Anyway, as we all think that investment is a strategic one, we are not going to argue over peanuts.

Third director: That acquisition may be strategic, but that is no reason to be light about it. I still do not understand why we should use a discount rate, i.e. the return we expect from FGA, that is lower than our WACC, all the more as synergies are already taken into account for the calculation of future cash flows. We are not paid as administrators to approve investments that are destroying shareholders’ value.
....

Fourth director: Jack, I do not understand why the WACC of JV goes from 8.7% to 7.8% when we are financing the acquisition of FGA with debt. This goes against some of my distant memories from the Vernimmen.

CFO: Well, that is quite bland. Obtaining debt at an after-tax cost of 3.9% in the UK, we avoid financing with equity at 7.6% for this investment. In the end, the WACC goes down to 7.8% instead of 8.7%, its level with all-equity. That amounts to good financial management, as we borrow cheaply at 3.9% instead of having to pay 7.6% on our equity.

Fifth director: That is all well, but aren't our shareholders going to bear more risk because of debt, and require a higher return on their equity. Do you take care of that in your reasoning ?

....

First director: Anyway, no matter what you say, I am against that acquisition which makes our return on equity at JV fall from 15% to 11% if it is all-equity financed. Sure, if we fund it with debt, the return on equity rises to 16,4%, but that is only a gearing effect, and as we all know, leverage does not create value. In addition to that, the return on equity is very important to our shareholders.

Fourth director: Well, dear fellow, the acquisition of FGA is going to make our net profit rise, whatever the financial structure, and that shows it is a good deal.

Third director: But of course, that is also true of our EPS (earnings per share) which goes up, and our shareholders are going to be happy, as the EPS is a per share indicator of the wealth of every shareholders.

....

Questions

1. What discount rate should JV use to get the NPV of the investment in buying FGA: 9% or 7.6% ? Why ?

2. Does the discount rate JV should use to get the NPV of the project depend on the financing structure for that acquisition, all debt or all equity ? Why ? What do you think of the second column of the table in Exhibit 2 ?

3. The return on equity at JV goes down right after the buying of FGA **(all equity financing)** Is the deal worth being completed, from a financial point of view ? Why ?

4. The return on equity at JV goes up right after the buying of FGA **(all debt financing)** Is the deal worth being completed, from a financial point of view ? Why ?

5. If the book equity per share at JV goes up right after the buying of FGA **(all equity financing)**, is the deal worth being completed from a financial point of view ? Why ?

6. If the net profit at JV goes up after the acquisition of FGA, is the deal worth being completed from a financial point of view ? Why ? Will your answer be different whether financing is with debt or with equity ?

7. If the EPS of JV goes up right after the buying of FGA, is the deal worth being completed from a financial point of view ? Why ?

8. If the NPV of the investment in buying FGA is positive for JV, is the deal worth being completed from a financial point of view ?

9. What is the best criteria to evaluate the opportunity for JV of completing that acquisition of FGA ? Is that operation worth being carried through ? If positive, what is the value created for JV ?

10. If in the heat of the battle on the equity market for the control of FGA, Marechali would bid higher than JV, how much more could JV raise its offer ? At that price level, what would the value creation for JV be ?

11. Make a list of all benefits and drawbacks of maintaining the trading of FGA shares after having gained the control of FGA. What would you do as CFO of JV. (N.B. There are no good or right answers to that question, there are only good and bad arguments)

Exhibit 1 : some additional elements

1.

	JV	**FGA**
P/E ratio 2011	25	21.3 on the basis of the JV offered price (48 Euros)
β	0.8	0.8
EPS 5 year CAGR	12% per year	10% per year

CAGR : compounded annual growth rate.

2.

	In United Kingdom	**In France**
Risk free rate	4.6 %	3.2 %
Risk premium	5.5 %	5.5 %
β	0.8	0.8
Cost of equity for an insurance company	4.6 % + 0.8 x 5.5 % = 9 %	3.2 % + 0.8 x 5.5 % = 7.6 %
Cost of capital for a debt-free insurance company.	9 %	7.6 %
After tax cost of debt for a debt free insurance company	3.9 %	2.5 %

3. NPV for JV of investing in buying FGA :

- at 7.6 % : + € 0.6 bn
- at 9 % : - € 0.45 bn

Exhibit 2: main financial parameters for JV

Parameters	**2011 figures**	**2011 figures after an acquisition of 100% of FGA (synergies included[1]) financed with**	
		100 % equity	*100 % debt*
Net profit	€ 1.2 bn	€ 1.6 bn	€ 1.312 bn
EPS	42 Euros	46.2 Euros	45.9 Euros
Book equity per share	280 Euros	415 Euros	280 Euros
Return on equity	15 %	11.1 %	16.4 %
Financial structure	100 % equity	100 % equity	82 % equity 18 % debt
WACC	9 %	8.7 %(1)	8.7 % x 82% + 2.5 % x 18% = 7.6 %

Source : JV

(1) Weighted average between the cost of equity in in UK (9%) and in France (7.6%) for insurance companies. Market value of JV : € 30 bn, market value of FGA : € 6.39 bn (based on JV's offer)

[1] Synergies are estimated at 100 million euros after-tax in 2011.