



Morpheus Aerospace Case Study

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Closely held and family controlled businesses that excel at the seven factors that characterize successful wealth creating family enterprises, as discussed in Highland Global's *The Seven Deadly Sins of Business Valuation: Closely Held and Family Controlled Businesses*, typically are able to lower the firm's cost of capital as compared to those firms that have yet to master the seven factors of successful transgenerational wealth creating enterprises. While this lower cost of capital may serve to increase the value of the company, patient capital arising from mastery of the seven factors, particularly good relations between management and shareholders, may change the investment options for the firm. This in turn may further enable the company to create long-term wealth by investing in value-adding projects that would otherwise be rejected if the company's cost of capital were higher.

Morpheus Aerospace, Inc. is currently assessing various investment options relating to expansion of its business. The investment options include the following opportunities:

- **Acquisition of a small aircraft manufacturing firm in Canada**—This acquisition is expected to cost roughly \$30 million and would generate additional net cash flow to invested capital of roughly \$3 million per year. The acquisition would also create additional synergies estimated at roughly \$1.5 million per year.
- **Expansion of the Company's operations in Latin America**—The expansion would cost an estimated \$15 million for additional facilities and infrastructure. The incremental net cash flow to invested capital is estimated at \$1.5 million but could be substantially higher should the company be able to expand sales throughout South America and the Caribbean as a result of its investment in the region.

- Acquisition of a publicly traded aerospace company, Royal Aerospace, in Great Britain**—Royal Aerospace is currently being courted by both Morpheus Aerospace, a closely held and family controlled business, and Troilis International, a publicly traded company listed in London, as a potential acquisition target. Royal Aerospace currently has net cash flow to invested capital of £0 and is expected to continue to generate no cash flow to invested capital in the future. Troilis International has offered £12 million for Royal Aerospace and seeks to achieve annual synergies of £2 million. Troilis International's weighted average cost of capital is 12%. Morpheus Aerospace has offered £15 million for Royal Aerospace with hopes of achieving annual synergies of £2 million and collateral benefits associated with expansion into the British market.

The following table provides a comparison of each of the three investment opportunities and the expected return.

Investment Opportunity	Cost or Investment	Incremental Annual NCFIV	Estimated Annual Synergies	Total Expected Return	Return on Investment
Acquisition of Canadian firm	\$30,000,000	\$3,000,000	\$1,500,000	\$4,500,000	15.00%
Expansion in Latin America	\$15,000,000	\$1,250,000	\$0	\$1,250,000	8.33%
Acquisition of Royal Aerospace	£15,000,000	£0	£2,000,000	£2,000,000	13.33%

Consider a situation where Morpheus Aerospace excels at the seven characteristics of successful transgenerational wealth creating enterprises. In addition, relations between the executive management, the Board of Directors, and the shareholders are highly favorable. The patient capital return requirements are lowered by a low Specific Company Risk Premium and the absence of any additional Family Business Risk Premium. As a result, Morpheus Aerospace' weighted average cost of capital is estimated at 10%.

With a 10% hurdle rate, Morpheus Aerospace' investment decision would be to invest in the acquisition of the Canadian firm, as this provides a return in excess of the required rate and, thus, creates value for the Company.

In the absence of any additional synergies or collateral benefits, the Company would reject the expansion in Latin America, as the return on the investment of 8.3% falls short of the Company's hurdle rate of 10%. Based on these assumptions, an investment in this project would ultimately destroy value for the Company. However, the Company may still choose to undertake this project if there is a probability that the collateral benefits of the expansion would increase the return on the investment to a 10% return on investment or greater.

Morpheus Aerospace would also create value for shareholders by investing in the acquisition of Royal Aerospace, as the 13.33% return is higher than the Company's

weighted average cost of capital (ignoring the impact of currency exchange). Suppose, however, that Morpheus Aerospace and Troilis International engage in a bidding war for Royal Aerospace. Troilis International increases their bid to £16.667 million. As a result, Troilis International's expected return on the investment is 12%, exactly equal to its weighted average cost of capital. This indicates that at the offered price the transaction would, theoretically, neither add value nor destroy value for Troilis' shareholders. Morpheus Aerospace, however, through a skillful use of leverage in its capital structure coupled with the patient capital associated with good relations with the shareholders, has managed to lower its weighted average cost of capital to 10%. Therefore, Morpheus Aerospace increases its offer for Royal Aerospace to £17.5 million, which still provides a return on the investment of 11.43%—higher than the Company's hurdle rate, suggesting that the investment will create value for the shareholders. In theory, Morpheus Aerospace could have increased the bid for the Royal Aerospace to a high of £20 million, which would have given the project a net present value of zero—the present value of the cash flows would have equaled the initial investment—and a return equal to that of the Company's hurdle rate of 10%.

Now, consider the case where Morpheus Aerospace has a great deal of dissent among the shareholders and relations between management and the family members are acrimonious. As a result of the increased risk associated with the family risk factors, at which the Company fails to excel, the cost of equity capital increases, which increases the Company's weighted average cost of capital to 15%. As a result, Morpheus Aerospace would forego the investment in the acquisition of Royal Aerospace at £15 million as well as the expansion in Latin America, both of which have returns that are significantly below the increased hurdle rate of 15%. With respect to the acquisition of the Canadian firm, Morpheus Aerospace would likely realize no increase in value from that investment as the return is equal to the firm's hurdle rate of 15%; thus, the net present value of the project is zero.

This should illustrate clearly how good shareholder relations and the ability of a company to excel at the factors that characterize a successful transgenerational wealth creating enterprise may ultimately impact the investment options for the company. Demand capital could adversely impact the ability of the company to invest in value-adding projects and thereby hinder long-term wealth creation for the shareholders. Patient capital would likely contribute to a healthy family enterprise and may expand the possible investment options for the company. This in turn may foster growth, stability, and long-term wealth creation through investment in projects that add value to the enterprise.