

Finance 552
Problems in Corporate Planning and Financing
Fall 2015: Daytime

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Office Hours: Mondays 12:00-1:00 p.m., Tuesdays 4:00-5:30 p.m. and by appt.

Course materials available on Canvas

DESCRIPTION:

This class deals with two important problems facing financial managers: managing the cash flowing through the business and financing company operations. We will use the case study approach to learn to address these problems. In addressing the first problem, the course will cover financial statement analysis, forecasting and financial planning, cash budgeting, managing growth, and working capital strategies. Our study of financing company operations will consider the principal sources of capital available to corporations and the ways in which companies can best utilize these sources to further operating goals and to create shareholder value.

The course is organized into three sections:

1. Short-Term Financial Analysis and Planning
2. Optimal Capital Structure and Long-Term Financing
3. Special Topics

The first part of the course examines financial management of short-term operations and the cash flowing through the business. The remaining sections examine issues related to the long-term financing of company operations. Section 2 presents an overview of various financing choices and analyzes the basic capital structure decision. In Section 3, we look at specialized financing situations such as project finance, leases, securitization, and convertible securities. In Section 3, we also discuss financial distress and dividends.

When you complete this course, you should be able to

- Analyze a company's financial statements and draw inferences about the firm's strengths and weaknesses.
- Use a computer spreadsheet to create pro forma financial forecasts.

- Understand the financial dimensions of working capital, including cash, trade credit, and inventory management.
- Create financing policies that best support company operating strategies.
- Identify and analyze the many aspects of corporate financing policy, including
 - the appropriate balance between debt and equity,
 - the proper mix of internal and external sources of capital,
 - the appropriate maturity profile and structure for liabilities, and
 - the most advantageous markets in which to raise capital.
- Understand the mechanics and appropriate uses of specialized financing vehicles such as project finance, leases and convertible securities.
- Appreciate the effect of company decisions to pay dividends or repurchase shares on firm value and know how to establish a practical payout policy.

The case method is the ideal way to study the topics addressed in this course to supplement the theoretical approach to this material traditionally taken in the MBA core. We will examine a sequence of practical problems to better understand the nature of those problems, and more importantly, to master the logic by which alternative policies can be evaluated.

PREPARATION:

Almost all of our class time will be devoted to discussion of assigned cases. To get the most out of class you must prepare conscientiously and participate actively in study group and class discussions. Failure to participate robs others of your perspective and increases the chances that the discussion will not be relevant to your interests and abilities. Please participate actively.

So what is conscientious case preparation? Read the case thoroughly; identify principal issues to be addressed in the case; attempt to analyze these issues using your common sense and any appropriate tools or techniques, and note any action recommendations implied by your analysis. Alternatively, if you find yourself hitting a roadblock, try to articulate what your problem is. Oftentimes, identifying roadblocks is as valuable as a complete analysis. You should expect to spend between two and three hours preparing each case.

For each case assigned you will note below that I have posed one or more preparation questions. The questions play several roles depending on the case. Usually the questions are simply guidelines to help you get started on your analysis. In some instances, I may give you additional information in the questions, or when the case is a mechanical one, I may ask you to perform specific calculations. You should not assume that answering all of the preparation questions necessarily constitutes a complete analysis. My general advice is always to read the preparation questions, but do not feel overly constrained by them.

Do not be surprised if after conscientious preparation you still feel there are some loose ends in the case you are not certain about. Your test of whether you are learning the material and progressing adequately should be how you feel after the class discussion, not before. You are doing fine if after a class discussion you believe you could adequately handle a similar situation in the future.

I will alternate between asking for volunteers and calling on individuals. **If you are not prepared, please notify me before class, and we can both avoid the embarrassment.** If you have spent appropriate time on the case but still feel unsure of your opinions, consider yourself prepared.

COURSE RESPONSIBILITIES:

Your grade in this course will be based on the following components:

Participation	30%
Group Case Writeups (4)	35%
Final Case Analysis	35%

Participation. Your participation grade will be based on your presence and attentiveness in class, my assessment of the extent to which you helped make the class a productive learning experience, and my assessment of the depth of your command of the material.

Group Case Writeups. During the quarter, you will be responsible for completing four group case writeups. You may choose the cases from the syllabus that you would like to use for this assignment; your writeup will be due at the beginning of the session in which we discuss the case (please submit hard copy in class). For the first writeup, you may choose any of the first four cases in the course syllabus assigned for the first section, Short-Term Financial Analysis and Planning (class sessions 2 through 5). The second writeup should be one of the cases we will discuss during the second section, Optimal Capital Structure and Long-Term Financing (sessions 7 through 11). The third writeup should be one of the cases in the third section, Special Topics (sessions 12-13 and 15-18). The fourth writeup should be any of the other allowed cases that your group has not already submitted. Note that the cases assigned for session 6 (Saginaw Parts) and session 14 (Convertible Securities) are not eligible for a group case writeup.

Your writeup should be a maximum of four double-spaced, typewritten pages, plus any exhibits. Your analysis should address the preparation questions included in the syllabus in addition to any useful analysis you deem appropriate. Do not summarize the case situation in any great detail. The reader should be assumed to be familiar with the general situation (as would be typical if an analysis like this were prepared for management). However you may wish to highlight aspects of the situation that might not be obvious to the reader or that you believe are especially important to your analysis.

Each group should consist of from 3-5 students, and you should retain the same group for each case writeup. If you would like to form your own group, please give me a list of names

of students in your group by Friday, Oct. 2. If you would like me to arrange a group for you, please let me know in the first class session.

Final Case Analysis. The final exam will be a written case analysis with specific questions. You will receive this case along with further details about the assignment at the end of class on Monday Dec. 7, and your writeup will be due on Sunday, Dec. 13 at 11:00 p.m. Completed final exams are to be submitted on Canvas.

MATERIALS:

The following materials are required for this course:

- A required packet of cases is available from the University Bookstore under the Finance 552 course title.
- **Robert C. Higgins**, *Analysis for Financial Management* (Eleventh Edition), Irwin/McGraw-Hill, 2016.

In addition, there are some resources that may serve as useful background reading. These books are on reserve at the Foster Business Library.

- **Jonathan Berk and Peter DeMarzo**, *Corporate Finance* (Third Edition), Pearson Education, 2014.
- **Richard A. Brealey, Stewart C. Myers and Franklin Allen**, *Principles of Corporate Finance* (Eleventh Edition), McGraw Hill, 2014.

I have posted spreadsheets with data from the case exhibits when available on Canvas. In addition, I have posted some general guidelines for thinking about the case, and occasionally a link to additional background information about the case.

TECHNOLOGY POLICY:

I encourage the use of laptops in class for class-related purposes such as note taking and accessing your financial models. Learning how to prepare financial models in Excel is an important objective of the class. However, I support the School's policy against accessing email, surfing the Internet, etc. during class. Please constrain the use of your laptop during class to class-related purposes.

MBA HONOR CODE:

I employ the policies and procedures espoused by the Foster School of Business Honor Code to maintain academic integrity in the course.

Course Schedule

SHORT-TERM FINANCIAL ANALYSIS AND PLANNING

Class 1 (Wednesday, Sept. 30): Determinants of Financial Structure

Read: Higgins, Chapter 2.

Prepare (in class): The Case of the Unidentified Industries- 2013

- a.) Match company financial data to differing industries. (There will be time in class to work together on this case.)

Class 2 (Monday, Oct. 5): Assessing the Financial Health of the Firm

Read: Higgins, Chapter 2.

Prepare: Sears Roebuck and Co. vs. Wal-Mart Stores, Inc.

- a.) What was Wal-Mart's return on equity for the most recent fiscal year? What was Sear's return on equity? Don Edwards was puzzled by these numbers because of Wal-Mart's reputation as a premier retailer and Sear's financial difficulties not long ago. What can we learn from looking at ROE?
- b.) What are the determinants of ROE for Sears and WalMart?
- c.) What other ratios are most important in evaluating the current performance of each of the two companies? Why?
- d.) How useful are financial ratios in evaluating the performance of each of the two companies?

Class 3 (Wednesday, Oct. 7): Financial Forecasting and Cash Budgeting

Read: Higgins, Chapter 3

Prepare: NanoLabs (Case Available on Canvas)

- a.) How has NanoLabs performed so far? What are the company's main strengths and weaknesses?
- b.) Why has NanoLabs borrowed increasing amounts despite its consistent profitability?
- c.) How much money will NanoLabs need? For how long, a few months or longer?
- d.) As a banker, would you approve NanoLabs' request for a larger loan? If so, what conditions would you put on the loan?

Class 4 (Monday, Oct. 12): Managing Working Capital

Read: Higgins, Chapter 4

Prepare: Ceres Gardening Company: Funding Growth in Organic Products

- a.) How has the company grown? What is its basic strategy, and how has this evolved?
- b.) What potential financial risks does Ceres face as it crafts its strategy for 2007?
- c.) Prepare a financial forecast for 2007.
- d.) How would you evaluate Ceres's marketing efforts? Should the GetCeres program be expanded? Why or why not?

Class 5 (Wednesday, Oct. 14): Financing Seasonal Operations

Prepare: Polar Sports, Inc.

- a.) What factors should Weir consider in deciding whether or not to adopt the level production plan?
- b.) What effect will shifting to level production have on the company's need for a bank loan? Prepare a financial forecast to estimate the company's funding needs with level production.
- c.) As the banker, would you be willing to extend the line of credit to more than \$4 million to finance level production? Why or why not? What other sources could substitute in part for bank lending if the lender is not willing to extend the present line of credit? Do you think it is feasible for Polar Sports to switch to level production?
- d.) How does the change in funding requirements affect the risk assumed by the various parties?
- e.) What are Weir's options, and what should he do?

Class 6 (Monday, Oct. 19): Managing Working Capital Risk

Prepare: Saginaw Parts Co. and the General Motors Corp. Credit Default Swap (this case is not eligible for a group case writeup)

- a.) What do the GM credit default swap prices indicate in terms of the risk to an auto parts supplier of extending credit to GM?
- b.) How could Doakes and Saginaw Parts use credit default swaps to protect against a major customer bankruptcy?
- c.) How does the cost of this insurance compare to Saginaw's profit on its GM business?
- d.) What are Saginaw's alternatives, and what should it do?

OPTIMAL CAPITAL STRUCTURE AND LONG-TERM FINANCING

Class 7 (Wednesday, Oct. 21): Long-Term Financing Alternatives

Read: Higgins, Chapter 6, pp. 201-208

Prepare: National Gypsum Products Corporation 2015 (Case Available on Canvas)

- a.) What are the advantages and disadvantages of the three methods NGP might use to raise the needed external capital?
- b.) Estimate NGP's pro forma book value leverage ratio ($D/D+E$) in early 2015, and their fiscal year 2015 coverage ratio and EPS under the three alternatives.
- c.) Which of the financing methods do you recommend? Why?

Class 8 (Monday, Oct. 26): Optimal Capital Structure- Interest Tax Shields

Read: Higgins, Chapter 6 Appendix (pp. 225-229)

Prepare: California Pizza Kitchen*

- a.) Evaluate CPK's strategy and operating performance. How would you characterize CPK's business risk? Why is CPK considering this transaction now?
- b.) For each scenario in Exhibit 9, calculate the marginal impact of the interest tax shield on the value of the firm, assuming that the new debt is permanent. Clearly state any additional assumptions you need to make.
- c.) Calculate the coverage, EPS and market value leverage ratios for the three scenarios in Exhibit 9. How many shares can they repurchase in each scenario, and at what price?
- d.) Is their line of credit a reasonable source of funding for this transaction? Why or why not?

*If you choose to use the CPK case for your group writeup, please submit responses to either the questions for Class 8 or the questions for Class 9; you do not need to submit responses to both sets of questions.

Class 9 (Wednesday, Oct. 28): Optimal Capital Structure- Signaling

Read: Higgins, pp. 217-224

Prepare: California Pizza Kitchen (cont.)

- a.) Using the data in Higgins Table 6.5 (p. 205), estimate CPK's bond rating under the alternative recapitalization scenarios. What are the implications of this analysis for CPK's cost of debt?
- b.) What is CPK's current WACC? How will the WACC change under each scenario?
- c.) What signal will the announcement of a deal such as this send to capital markets?
- d.) What are the advantages and disadvantages to CPK of increasing its leverage?
- e.) What should CPK do, and why? Be specific.

Class 10 (Monday, Nov. 2): Optimal Capital Structure- Distress and Financial Flexibility

Read: Higgins, pp. 208-216

Prepare: Diageo plc

- a.) How has Diageo historically managed its capital structure?
- b.) How would you apply the tradeoff theory of capital structure to Diageo's business?
What is the present value of the tax shield, based on the current capital structure?
- c.) Based on the results of the model, what recommendation would you make for Diageo's future capital structure? Why doesn't Diageo have more debt? What are the disadvantages of more debt for them?
- d.) Should Diageo change its target capital structure?

Class 11 (Wednesday, Nov. 4): Optimal Capital Structure- Incentives

Prepare: Sealed Air Corporation's Leveraged Recapitalization (A)

- a.) Why did Sealed Air undertake a leveraged recapitalization? What other changes are happening at Sealed Air during this period? How are these changes related?
- b.) How will the transaction affect leverage ratios, coverage ratios, and EPS? For your analysis, assume the deal took place 1/1/89. Estimate the pro forma impact on a 1/1/89 balance sheet and 1989 income statement.
- c.) What are the alternative uses of excess cash? Why did Sealed Air choose an extraordinary dividend rather than a share repurchase of comparable size?
- d.) Why did Sealed Air's investor base turnover completely after the recap? Is this something managers should be concerned about?
- e.) Do you think this transaction was a good idea for Sealed Air? Would such an increase in leverage be good for all companies? Why or why not?

SPECIAL TOPICS

Class 12 (Monday, Nov. 9): Project Financing

Prepare: Petrolera Zuata, Petrozuata C.A.

- a.) What are the costs and benefits of using project finance instead of traditional corporate debt issued by the sponsors?
- b.) What are the most important risks of this project, and how are they mitigated?
- c.) Will the bonds get an investment grade rating? Why or why not?
- d.) Which source of debt should the project target?
- e.) Would you invest in Petrozuata as Conoco?

Wednesday, Nov. 11: No Class (Veteran's Day, University Holiday)

Class 13 (Monday, Nov. 16): Leases

Prepare: Leasing Computers at Persistent Learning

- a.) How would each of the alternatives (cash purchase, fair-market-value lease, or one-dollar-purchase lease) affect Persistent's financial statements?
- b.) What are the advantages of each alternative?
- c.) What business risks and responsibilities does the firm accept with each?
- d.) Which leasing alternative do you recommend for Persistent? Why?

Class 14 (Wednesday, Nov. 18): Securitization and Convertible Securities

Read: Higgins, Appendix to Chapter 5

Read: Securitization Articles (Posted on Canvas)

Convertible Securities (this note is not eligible for a group case writeup)

- a.) What are the advantages and disadvantages of convertible securities?
- b.) What is the bond worth today if you immediately convert it?
- c.) What are the cash flows to the bond if you hold it to maturity?

Class 15 (Monday, Nov. 23): Convertible Securities

Prepare: Corning: Convertible Preferred Stock

- a.) Does Corning need to raise external capital now? Must it be equity capital?
- b.) What are the advantages and disadvantages to Corning of issuing convertible preferred stock?
- c.) What is the value of the convertible preferred stock if an investor chooses to convert immediately after the convertible stock is issued?
- d.) What is the value of the dividend stream that an investor will receive, assuming the convertible preferred stock is held until the mandatory conversion date?
- e.) What is the convertible preferred stock worth today? Why?
- f.) Who are the likely buyers of this security? Why?
- g.) What should Corning do?

Wednesday, Nov. 25: No Class (Thanksgiving)

Class 16 (Monday, Nov. 30): Financial Distress and Bankruptcy

Prepare: The Loewen Group, Inc. (Abridged)

- a.) By 1999, Loewen is apparently in trouble. Was the distress primarily the result of external factors, such as economic conditions, or internal factors, such as management decisions? Did Loewen's distress result primarily from operating or financial decisions? What analyses might you conduct to support your answer to these questions?

- b.) How costly do you think financial distress is apt to be to Loewen? Why?
- c.) How serious is the situation? Why? What are Loewen's immediate cash flow needs?
- d.) What alternatives are available to Loewen now? What are the primary advantages and disadvantages of these alternatives?
- e.) Which option do you recommend, and why?

Class 17 (Wednesday, Dec. 2): Financial Distress and Bankruptcy

Prepare: The Tip of the Iceberg: JP Morgan Chase and Bear Stearns (A)

- a.) Consider a commercial bank in the 1970s. What would each side of its balance sheet have looked like? How does this compare to a typical investment bank then?
- b.) What activities did Bear Stearns undertake? Was it a commercial bank or an investment bank?
- c.) SEC Chairman Christopher Cox noted that Bear Stearns was an adequately capitalized institution as of March 10, 2008. Do you agree with his assessment? Are well-capitalized financial institutions invulnerable to crisis?
- d.) How does Bear's mix of financing sources compare to other similar financial institutions?
- e.) How would Bear be affected by a potential bankruptcy? What are the potential costs of financial distress for Bear?
- f.) Should Bear have accepted JPMC's offer? Should JPMC have purchased Bear?

Class 18 (Monday, Dec. 7): Payout Policy

Prepare: Payout Policy at Google (Case available on Canvas)

- a.) What are Google's funding needs? Will it need the \$20 billion in cash to finance its operations?
- b.) Why do firms pay dividends? What are the disadvantages of paying dividends? How do these considerations change if the payout is a share repurchase?
- c.) If Google were to pay \$20 billion as a special dividend, what would be the effect on market value? On the share price? On net income? On earnings per share? What if Google repurchased shares instead? Assume a 1% rate of interest on any cash balance and a 3% interest rate on the debt. Also assume that the deal takes place in early October 2014. Estimate the impact on the Sept. 30, 2014 balance sheet and the income statement for the next 12 months. (HINT: Solve this problem in the Modigliani-Miller setting, and think qualitatively about what would change in the real world.)
- d.) What should Patrick Pichette recommend to Google's board?

Class 19 (Wednesday, Dec. 9): Summary and Course Overview