

Finance 552
Problems in Corporate Planning and Financing
Fall 2017

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Office Hours: 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 address these problems. Regarding 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, securitization, and convertible securities. In Section 3, we also discuss financial distress and payout policy.

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.
- Identify and analyze the many aspects of corporate financing policy, especially the appropriate balance between debt and equity.
- Understand the mechanics and appropriate uses of specialized financing vehicles such as project finance, securitization, 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 class discussion.

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 five cases in the course syllabus assigned for the first section, Short-Term Financial Analysis and Planning (class sessions 2 through 6). The second writeup should be one of the cases we will discuss during the second section, Optimal Capital Structure and Long-Term Financing (sessions 8 through 12). The third writeup should be one of the cases in the third section, Special Topics (sessions 13 through 18). The fourth writeup should be any of the other eligible cases that your group has not already submitted. Note that the case assigned for Class 7 (Credit Default Swaps) and the note assigned for Class 15 (Convertible Securities) are not eligible for a group case writeup.

Your writeup should be a maximum of four double-spaced 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, Sept. 29. There will also be time in class during the first class session to facilitate group formation.

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. 4, and your writeup will be due on Sunday, Dec. 10 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. This course pack is also available electronically at the following link on the HBS website:
<http://cb.hbsp.harvard.edu/cbmp/access/68520692>
- **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* (Fourth Edition), Pearson Education, 2017.
- **Richard A. Brealey, Stewart C. Myers and Franklin Allen**, *Principles of Corporate Finance* (Twelfth Edition), McGraw Hill, 2017.

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. 27): Determinants of Financial Structure

Read: Higgins, Chapter 2

Prepare (in class): Financial Ratio Exercise (Case Available on Canvas)

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

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

Prepare: J.C. Penney Company

- a.) Evaluate JCP's strategy. What are the company's strengths?
- b.) What went wrong? Is JCP's current position primarily the result of operating decisions, financial decisions, or bad luck?
- c.) Evaluate JCP's historical operating performance.
- d.) How has JCP managed its working capital in the recent past? Is there an opportunity to squeeze more cash from any of these accounts?
- e.) How much money does JCP need, and for what purpose? To answer this question, prepare a sources and uses statement for 2013 (similar to Exhibit 7 in the case). Assume that JCP will experience a \$1.5 billion net loss for 2013 and that a cash balance of \$1.0 billion is required for JCP to operate efficiently.
- f.) How serious is the situation? What are JCP's alternatives, and what should they do?

Class 3 (Wednesday, Oct. 4): 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. 9): Cost of Capital

Read: Higgins, pp. 298-311

Prepare: Intel Build vs Buy: Weighted Average Cost of Capital (case available on Canvas)

- a.) How did Andrews calculate her WACC? Do you agree with her assumptions?
- b.) Calculate the cost of equity using at least three different techniques.
- c.) What is your estimate of the WACC for Intel?
- d.) Is the WACC for Intel appropriate to use as a discount rate for this build vs. buy decision? Why or why not?

Wednesday, Oct. 11: No Class (I will be attending a conference.)

Class 5 (Monday, Oct. 16): Managing Working Capital

Read: Higgins, Chapter 4

Prepare: Ceres Gardening Company: Funding Growth in Organic Products

- a.) Evaluate Ceres' historical operating performance and marketing efforts. What are the company's strengths?
- b.) How has the company grown? What is its basic strategy, and how has this strategy evolved?
- c.) Prepare a financial forecast for 2007. What do you learn from this forecast?
- d.) Should the GetCeres program be expanded? Why or why not?

Class 6 (Wednesday, Oct. 18): 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 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.) What are Weir's options, and what should he do?

Class 7 (Monday, Oct. 23): Managing Working Capital Risk

Prepare: Credit Default Swaps (case and study questions available on Canvas; this case is not eligible for a group case writeup)

OPTIMAL CAPITAL STRUCTURE AND LONG-TERM FINANCING

Class 8 (Wednesday, Oct. 25): Long-Term Financing Alternatives

Read: Higgins, pp. 201-208

Prepare: National Gypsum Products Corp. 2017 (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 2017, and their fiscal year 2017 coverage ratio and EPS under the three alternatives.
- c.) Which of the financing methods do you recommend? Why?

Class 9 (Monday, Oct. 30): 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 9 or the questions for Class 10; you do not need to submit responses to both sets of questions.

Class 10 (Wednesday, Nov. 1): 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 11 (Monday, Nov. 6): Optimal Capital Structure- Distress and Financial Flexibility

Read: Higgins, pp. 208-216

Prepare: Diageo plc

- a.) How has Diageo historically managed its capital structure? Is their target capital structure reasonable?
- 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? Qualitatively, are distress costs likely to be large or small for Diageo? Why?
- 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 12 (Wednesday, Nov. 8): 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 their 1/1/89 capitalization 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.) How did the market react to the announcement of this deal? What factors might explain this reaction?
- e.) Do you think this transaction was a good idea for Sealed Air? Why or why not?

SPECIAL TOPICS

Class 13 (Monday, Nov. 13): 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? Why?
- e.) Would you invest in Petrozuata as Conoco?

Class 14 (Wednesday, Nov. 15): Securitization

Prepare: Fraikin S.A.

- a.) What business is Fraikin in? How well has the company been doing?
- b.) How will the securitized loan work? Why does securitized lending appear to carry a lower interest rate than more conventional loans? How does a whole business securitization differ from a more conventional securitization? What is “ring fencing?”
- c.) Using the company’s 2003 balance sheet, how would Fraikin’s debt-to-total capital employed ratio change if the company raised €420 million by securitizing €500 million of its equipment for lease? What does this say about Fraikin’s creditworthiness after the securitization relative to before?
- d.) For each of the three financing alternatives, how much debt capital will be available? What will be the annual interest cost of the debt (use the 12-month Euribor rate as the benchmark Euribor rate unless otherwise specified)?
- e.) From Fraikin’s perspective, what are the principal strengths and weaknesses of the three financing alternatives described in the case?
- f.) Which of the three alternatives should Fraikin use? Why?

Class 15 (Monday, Nov. 20): Convertible Securities

Read: Higgins, Appendix to Chapter 5

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

- a.) What are the advantages and disadvantages of convertible securities?

Wednesday, Nov. 22: No Class (Thanksgiving)

Class 16 (Monday, Nov. 27): Convertible Securities (cont.)

Prepare: Corning: Convertible Preferred Stock

- a.) Evaluate Corning’s operating and financing strategy. How has the firm performed? How has it raised capital in the past?
- b.) Estimate Corning’s major sources and uses next year. Does Corning need to raise external capital now? Must it be equity capital?
- c.) What are the advantages and disadvantages to Corning of issuing convertible preferred stock?
- d.) What is the value of the convertible preferred stock if an investor chooses to convert immediately after the convertible stock is issued?
- e.) 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?
- f.) What is the convertible preferred stock worth today? Why?
- g.) What should Corning do?

Class 17 (Wednesday, Nov. 29): Financial Distress and Bankruptcy

Prepare: The Loewen Group, Inc. (Abridged)

- a.) What was Loewen's strategy? What was Loewen doing well?
- b.) By 1999, Loewen was apparently in trouble. Was the distress primarily the result of bad operating decisions, poor financing decisions, or bad luck? What analyses might you conduct to support your answer to this question?
- c.) What was Loewen's target capital structure? How close were they to their target? Was their target sensible? How costly do you think financial distress was apt to be to Loewen? Why?
- d.) How serious was the situation? Why? What were Loewen's immediate cash flow needs?
- e.) What alternatives were available to Loewen? What were the primary advantages and disadvantages of these alternatives?
- f.) Which option do you recommend, and why?

Class 18 (Monday, Dec. 4): 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 and short-term investments, 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 market value capitalization 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. 6): Summary and Course Overview