

UNIVERSITY OF WASHINGTON
Graduate School of Business Administration
EMBA 504
Northwest & Beyond Section
FINANCIAL MANAGEMENT
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COURSE OBJECTIVE

"All decisions are financial decisions," or so wrote Arthur Stone Dewing in his monumental 1953 text on corporation finance. In a literal sense, Dewing overstates the case, but interpreted more broadly his statement does reflect the pervasive importance of money and finance in personal and business affairs. For even when actions or decisions are not motivated by financial considerations, they invariably have monetary repercussions. Moreover, financial measures such as earnings per share, return on equity, and debt-to-equity ratio have become the yardsticks by which business performance is measured; so even when no decisions are involved, simply keeping score involves finance.

EMBA 504 encompasses what I believe every general manager should know about finance. Its purpose is to give you a thorough introduction to financial management that blends appropriate amounts of relevant theory with practical application. Said another way, I want to help you develop a "financial way of thinking." If we are jointly successful, the course will equip you to participate fully and creatively in the resolution of the many financial issues facing your organization. Most of you will not be ready to replace the chief financial officer or the treasurer after this class, but all of you should be able to work productively with these individuals and to assess the financial implications of your own decisions.

We will begin with a look at the very practical arts of financial statement analysis and financial planning. Here you will build on the foundation constructed in financial accounting to assess the financial performance of a company and to plan its future performance.

You will then systematically examine three recurring financial challenges: what resources to acquire or sell, how to finance a business, and how much cash to distribute to owners in the form of dividends or share repurchases. We will look at each topic on the practical level of how each affects accounting measures of performance and on the conceptual level of whether each creates or destroys value.

REQUIRED MATERIALS

1. Higgins, Robert C., *Analysis for Financial Management*, 6th. Edition, Irwin/McGraw-Hill, 2000.
2. Packet of cases and readings.

GRADING

Your grade will be based in equal part on three things: five brief applications assignments, daily class work including distance learning assignments, and a final exam.

My assessment of your in-class work will be based on three things: 1) your presence (it's hard to contribute to class learning when you are not there) 2) my assessment of the extent to which you helped to make the class a productive learning experience, 3) and my assessment of the depth of your command of the material. If you find it necessary to miss any classes during the term, you can partially atone for your sins by preparing for submission a two or three page analysis of the readings and cases you missed.

In past years, some of your colleagues have devoted excessive worry time to grades and to the grading process. I see grades serving three purposes: an incentive to prepare, a recognition of superior performance, and a means of helping you decide how well you are progressing. If the prospect of being graded begins to detract from your healthy enthusiasm for learning the subject, if grade anxiety becomes a problem, something is wrong and we should talk.

Some have likened this course to a 13-course dinner in which most people partake of multiple courses but few consume the whole meal. If you tend to be a light eater financially speaking, don't be overly concerned. As long as you are getting the basics, you'll do just fine. It may mean that your grades will not be as high as those of the CFOs, treasurers and commercial bankers in the class, but it's probably not reasonable for you to expect otherwise. And on the plus side, you'll learn a lot more per tuition dollar than your more financially literate colleagues.

DAILY PREPARATION

Most 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. So please participate actively.

So what is conscientious case preparation? Read the case thoroughly; identify the 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.

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 to help you get started on your analysis, and you should not feel constrained by them. Nor should you assume that answering all of the preparation questions necessarily constitutes a complete analysis. In other 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. 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. If it were otherwise, there would be nothing for you to learn in class, and I would have been guilty of selecting a case that was too simple. 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 tend to vacillate between asking for volunteers and calling on individuals. **If you are not prepared, please notify me before class, and we can both avoid some embarrassment.** If you have spent several hours on the case, but still feel unsure of your opinions, count yourself prepared. If you have made the effort, you should never feel embarrassed by the result.

SESSION 1 ASSIGNMENTS

ASSESSING FINANCIAL PERFORMANCE AND FINANCING OPERATIONS

1. Thursday, April 5 -- **Financial Planning**

Read: *Analysis for Financial Management*, (TEXT) Skim as necessary Chapters 1, 2 and 3.

Prepare: Spencer Sporting Goods

- a) What are Spencer's main strengths and weaknesses at the present time?
- b) Why does this profitable company need money?
- c) In your estimation, how much money does Spencer need? For how long, a few months or longer?
- d) As a banker, would you be willing to loan Spencer the needed amount? On what conditions?

2. Thursday, April 5 -- **Managing Growth**

Read: Text chapter 4.

Prepare: Spencer Sporting Goods (continued)

- a) What was Spencer's sustainable growth rate over the past 4 years? How do these sustainable growth rates compare to actual growth rates in sales? What conclusions do you draw from this comparison?

3. Friday, April 6 – **Assessing Financial Performance**

Prepare: The Battle for Value: Federal Express Corporation vr. United Parcel Service of America, Inc. (Abridged) UVA F 1124

- a) Describe the competition in the overnight package delivery industry and the strategies by which these two firms are meeting the competition. What are the enabling and inhibiting factors facing the two firms as they pursue their goals? Can either firm hope to attain sustainable competitive advantage in this business?
- b) Why did FedEx's stock price decline at J.C. Penney's announcement? Assuming a perfectly efficient stock market, how might one interpret this loss of \$85 million in FedEx's market value of equity?
- c) How have Federal Express and United Parcel Service performed since the mid-1980s? Which firm is doing better? What insights do you derive from the two firms' financial statements, financial ratios, stock price performance, and economic profit (or EVA)? In general, what is your assessment of EVA as a measure of performance?
- d) If you had to identify *one* of these companies as "excellent" which would you choose? On what basis? More generally, what is "excellence" in business?

4. Friday, April 6 – **Introduction to Financial Markets**

Read:

- "Cash is King," Chapter 5, Copeland, Tom, Tim Koller and Jack Murrin, *Valuation: Measuring and Managing the Value of Companies*, 3e, Wiley, 2000, pp. 73 – 87, and
- "Buffett on High Premium Acquisitions," Berkshire Hathaway, Inc. 1981 Annual Report.

Prepare: Warren E. Buffett, 1995

UVA F 1160

- a) What is the possible meaning of the changes in stock price for GEICO and Berkshire Hathaway on the day of the acquisition announcement? Specifically, what does the \$718 million gain in Berkshire's market value of equity imply about the intrinsic value of GEICO? (Note that Berkshire owned 33.25 million shares before the acquisition was announced.)

- b) Based on Value Line's forecasted information, what is the range of possible intrinsic value for GEICO? What questions might you have about this estimated range?
- c) How well has Berkshire Hathaway performed? In the aggregate? In its investment in Scott & Fetzer? In its investments in earlier purchases of GEICO stock? In its investments in convertible preferred securities?
- d) What is "intrinsic value" in Warren Buffett's perspective, and why is it accorded such importance? How is it estimated? What are the alternatives to intrinsic value, and why does Buffett reject them?
- e) Critically assess Buffett's investment philosophy, and prepare to identify points where you agree and disagree with him.
- f) Should Berkshire shareholders endorse the acquisition of GEICO? 7.

5. Saturday, April 7 – **Long-term Financing and Liability Management**

Read: Higgins, Chapters 5 and 6.

Prepare: American Home Products

- a) How much business risk does American Home Products face? How much financial risk would the company face at each of the proposed levels of debt shown in Exhibit 3? How much potential value, if any, can AHP create for its shareholders at each of the proposed levels of debt?
- b) What capital structure would you recommend as appropriate for AHP? What are the advantages of leveraging this company? The disadvantages? How would leveraging up affect the company's taxes? How would the capital market respond to an increase use of debt finance?
- c) How might AHP implement a more aggressive capital structure policy? What are the alternative methods for leveraging up?
- d) In view of AHP's unique corporate culture, what arguments would you advance to persuade Mr. Laport or his successor to adopt your recommendation?

6. Saturday, April 7 – **Introduction to Capital Structure Theory**

Read: Higgins, Chapter 6 Appendix

Prepare: American Home Products (Continued)

SESSION 2 ASSIGNMENTS

EVALUATING INVESTMENT OPPORTUNITIES AND ESTIMATING CAPITAL COSTS

7. Thursday, May 3 – Relevant Cash Flows in Investment Analysis

Read: Higgins, Chapter 7.

Prepare: Empirical Chemicals Ltd. The Merseyside Project (A) UVA-F-1020 ver. 2.3

- a) What changes, if any, should Frances Trelawney ask Jim Hawkins to make in his discounted-cash flow analysis? Why? What should Trelawney be prepared to say to the Transport Division, the director of Sales, and her assistant plant manager?
- b) How attractive is the Merseyside project? By what criteria?
- c) Should Trelawney continue to promote the project for funding?

8. Thursday, May 3 – Introduction to Capital Budgeting

Prepare: Empirical Chemicals Ltd. The Merseyside Project (A) (Continued).

9. Friday, May 4 – Risk, Return and Diversification

Read: Brealey, Richard C. and Stewart Myers, *Principles of Corporate Finance*, pp. 153 – 180 and 187 – 203.

Prepare: Beta Management Company

- a) Calculate the variability (standard deviation) of the stock returns of California REIT and Brown Group during the past two years. How variable are they compared with Vanguard Index 500 Trust? Which stock appears riskiest?
- b) Suppose Beta's position had been 99% of equity funds invested in the index fund, and 1% in the individual stock. Calculate the variability of this portfolio using each stock. How does each stock affect the variability of the equity investment, and which stock is riskiest? Explain how this makes sense in view of your answer to Question a above.
- c) Perform a regression of each stock's monthly returns on the Index returns to compute the "beta" for each stock. How does this relate to the situation described in Question b above?
- d) How would you expect the expected return for each stock to relate to its riskiness?

10. Friday, May 4 – Introduction to the Capital Asset Pricing Model

Prepare: Beta Management Company (Continued)

11. Saturday, May 5 – Risk Analysis and the Cost of Capital

Read: Higgins, Chapter 8 including the appendix.

12. Saturday, May 5 – Estimating Capital Costs

Prepare: Procter and Gamble: Cost of Capital UVA-F-0931

- a) Critically evaluate Mary Shiller's Analysis.
- b) Critically evaluate each of the six points in Ron Emory's memo to Mary Shiller:
 - Does it make sense to look at companies other than Procter and Gamble? Why?
 - Is Emory's method for computing yield to maturity correct?
 - Are the other K_e estimation methods as good as CAPM?
 - Should the company compute the cost of retained earnings as part of the cost of capital?

- Is anything lost if Mary's recommendation is written in terms of IRR rather than NPV?
 - Since Clorox is more conservatively financed, do you expect its weighted average cost of capital to be greater or less than P&G's? Why?
- c) Based on your assessment of Emory's suggestions, what is your estimate of P&G's cost of capital?
- d) What is Clorox's cost of capital?

SESSION 3 ASSIGNMENTS

BUSINESS VALUATION AND CORPORATE RESTRUCTURING

13. Thursday, May 31 – **Business Valuation**

Read: Higgins, Chapter 9.

Prepare: The Takeover of the Norton Company 9-291-002 rev. December 15, 1997

- What is BTR's business strategy?
- Does Norton fit BTR's acquisition criteria?
- How should BTR decide what to bid for Norton?
- Which valuation approaches described in the appendix appear useful in attempting to value Norton?

14. Thursday, May 31 – **Mergers and Acquisitions**

Prepare: The Takeover of the Norton Company (continued)

15. Friday, June 1 – **Bankruptcy Mechanics**

Read:

- “Note on Bankruptcy in the United States” Harvard Business School, N9-294-068
- Weiss, Lawrence, “The Bankruptcy Code and Violations of Absolute Priority,” *Journal of Applied Corporate Finance*, Spring, 1991, pp. 7 – 18.

Prepare: National Convenience Stores

- What pushed NCS into Chapter 11? Was it just bad luck, or was there more involved?
- What are the creditor-claims against NCS? What are the claims of each creditor class?
- Should NCS be reorganized or liquidated? If liquidated, how would the cash be distributed?
- What is management's operating plan? What do you think of the plan?
- What is a reorganized NCS worth?
- How should the reorganized company be capitalized?

16. Friday, June 1 – **Reorganization in Bankruptcy**

Prepare: National Convenience Stores (continued)

17. Saturday, June 2 – **Hostile Takeovers**

Prepare: Gulf Oil Corporation – Takeover 9-285-053 rev. December 8, 1988

- Why was Gulf attacked? What are the sources of value bidders hope to reap from the acquisition of Gulf?
- Assess the performance of Gulf's management in running the company. Does Gulf's exploration program appear economically viable?
- How much is Gulf worth per share to Socal? How much are competing bidders likely to bid? How much should Mr. Keller bid?
- Assess Mr. Lee's response to the attack on Gulf. What should he do now?
- Who are the winners and losers in takeover battles such as this? Are the many takeover bids and restructurings good for the oil industry?

18. Saturday, June 2 – **Corporate Governance**

Prepare: Gulf Oil Corporation – Takeover (continued)

FINAL EXAM

WRITTEN ASSIGNMENT: 3 -5 PAGES, DOUBLE-SPACED, TYPEWRITTEN, PLUS EXHIBITS, IF ANY

Prepare: Friendly Greeting Cards, Inc. 9-293-135. Rev. June 18, 1993.

- a) As Ms. McConville, what advice would you give to Ms. Beaumont in early 1988?