UNIVERSITY OF WASHINGTON
Graduate School of Business Administration
EMBA 504
Puget Sound Section

FINANCIAL MANAGEMENT
Spring 2001

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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.

Most of residency week will be devoted to 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. We will also consider commercial banks as providers of money to companies and the manner in which they evaluate lending opportunities.

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 five brief applications assignments, daily class work, and a final exam.

Your daily class work grade will a 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 absences 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.

ASSIGNMENTS

ASSESSING FINANCIAL PERFORMANCE AND FINANCING OPERATIONS

1. Sunday, April 1 **-- 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. Sunday, April 1 **-- 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. Monday, April 2 **-- Cash Budgeting**

   Prepare: Hampton Machine Tool Company 9-280-103 Rev. 12/3/91

   a) Why can't a profitable company like Hampton repay its loan on time and why does it need more bank financing? What major developments between November 1978 and August 1979 have contributed to this situation?

   b) Based on the information in the case, prepare a projected cash budget for the four months, September through December 1979, a projected income statement for the same period, and a pro forma balance sheet as of December 31, 1979. (Your income statement need not be monthly. You can make one covering the entire four months.)

   c) Review the results of your forecast. Do the cash budgets and pro forma financial statements yield the same results? Why, why not?

   d) Critically evaluate the assumptions on which your forecasts are based. What developments could alter your results? Is Mr. Cowins correct in his belief that Hampton can repay the loan in December?

   e) What action should Mr. Eckwood take on Mr. Cowins' loan request? What are the major risks associated with the proposed loan? What other alternatives does Mr. Eckwood have and what are the pros and cons? What would you do?

   f) Why did Hampton repurchase a substantial fraction of its outstanding common stock? What is the impact of this repurchase on Hampton's financial performance? Critically assess Hampton's dividend policy. Do you agree with Mr. Cowins' proposal to pay a substantial dividend in December?

4. Monday, April 2 **-- Bank Lending**

   Prepare: Hampton Continued

5. Tuesday, April 3 – **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?

6. Tuesday, April 3 – **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. Wednesday, April 4 – **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 your 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?

8. Wednesday April 4 – **Introduction to Capital Structure Theory**

Read: Higgins, Chapter 6 Appendix

Prepare: American Home Products (Continued)

9. Friday, April 13 – **Leveraged Restructuring**

Prepare for submission Application Exercise 1, Financial Analysis.

Read:

a) Smith, Clifford, "Raising Capital: Theory and Evidence," Journal of Applied Corporate Finance,

b) Weber, Joseph, "What To Do With All That %#* Cash," *Business Week,* November 20, 2000, p. 160.

Prepare: Sealed Air Corporation's Leveraged Recapitalization (A) 9-294-122 May 10, 1994

a). Why did Sealed Air undertake a leveraged recapitalization? Do you think that it was a good idea? For whom?

b). Is pursuing a program of manufacturing excellence such as World Class Manufacturing (WCM) inconsistent with "levering up"?

c). Why did Dermot Dunphy, the CEO, feel it was necessary to change the company's priorities and incentive structure following the recap?

d). Why did Sealed Air's investor base turnover completely after the recap? Is this something managers should be concerned about?

e). Was the constraint imposed on capital expenditures under the bank lending agreement good or bad for the company? Do you think managers will be able to successfully renegotiate this covenant?

f). Would such an increase in leverage be good for all companies? Why or why not?

10. Friday, April 13 **– Distribution Policy**

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

EVALUATING INVESTMENT OPPORTUNITIES AND ESTIMATING CAPITAL COSTS

11. Saturday, April 21 **– Relevant Cash Flows in Investment Analysis**

Prepare for submission Application Exercise 2, Discounted Cash Flow Problems.

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?

12. Saturday, April 21 – **Introduction to Capital Budgeting**

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

13. Friday, April 27 – **Risk, Return and Diversification**

    Prepare for submission Application Exercise 3, Capital Structure Choices.

    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?

14. Friday, April 27 – **Introduction to the Capital Asset Pricing Model**

    Prepare: Beta Management Company (Continued)

15. Saturday, April 28 – **Risk Analysis and the Cost of Capital**

    Read: Higgins, Chapter 8 including the appendix.

16. Saturday, April 28 – **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?

17. Saturday, May 5 – **Project Capital Costs**

Read:

- Bruner, Robert F. Kenneth M. Eades, Robert S. Harris, Robert C. Higgins, "'Best Practices' in Estimating the Cost of Capital: Survey and Synthesis," *Financial Practice and Education*, Spring/Summer 1998, pp. 13-28.
- Higgins, Robert C. "Levering and Unlevering Beta"

Prepare: Boeing 777 UVA-F-1017 ver.1.5

a) What is an appropriate required rate of return against which to evaluate the prospective IRRs from the Boeing 777?

- When you used the capital-asset-pricing model (CAPM), which risk premium and risk-free rate did you use? Why?
- Which capital structure weights did you use? Why?

b) Judged against your weighted-average cost of capital, how attractive is the Boeing 777 project?

- Under what circumstances is this project economically attractive?
- What does your sensitivity analysis (either the analysis presented in the case or another that you have done on your own) reveal about the nature of Boeing's gamble on the 777?

c) Should Boeing have launched the 777 in October 1990?

18. Saturday, May 5 – **Introduction to Derivative Securities and Real Options**

Read: Brealey, Richard C. and Stewart Myers, *Principles of Corporate Finance*, pp. 583 – 609 and 619 – 629. As interest dictates, 629 – 638.

BUSINESS VALUATION AND CORPORATE RESTRUCTURING

19. Friday, May 11 – **Business Valuation**

Prepare for submission Application Exercise 4, Estimating Capital Costs.

Read: Higgins, Chapter 9.

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

a) What is BTR's business strategy?

b) Does Norton fit BTR's acquisition criteria

c) How should BTR decide what to bid for Norton?

d) Which valuation approaches described in the appendix appear useful in attempting to value Norton?

20. Friday, May 11 – **Mergers and Acquisitions**

Prepare: The Takeover of the Norton Company (continued)

21. Friday, May 25 **– Early Stage Financing**

Read:

- Zider, Bob, "How Venture Capital Works," *Harvard Business Review*, November–December. 1998, pp. 131 – 139.
- Bhide, Amar, "Bootstrap Finance: The Art of Start-ups," *Harvard Business Review,* November-December 1992, pp. 109 – 117.

Prepare: Preview Travel (A) 9-899-085. October 19,1998

When preparing this case, please assume the following:

- Preview Travel's preferred shares all have equal value, regardless of the shares' series.
- Preferred shares are convertible into common shares when the firm goes public at the rate of 1 preferred share = 1.91 common shares.
- Even though preferred shares have priority if the firm liquidates, assume that each preferred share is equal in value to 1.91 common shares.
- Preview Travel's outstanding common shares (including warrants) at the time of the preferred series issue dates are indicated as follows"

Series	# Outstanding common shares (including warrants)
A	1.826 million
B	2.781 million
C	5.301 million
D	6.962 million
E	7.320 million

a) How has Preview Travel financed its operations to this point? For each of the five rounds of financing summarized in Exhibit 2, estimate the values of the firm's outstanding preferred and common shares immediately after the preferred stock issue.

b) From the company's perspective, what are the principal advantages and disadvantages of the following sources of equity financing: i) "angel" investors, ii) venture capital firms, iii) strategic investors, and iv) public stock offering (IPO)?

c) At QuadMedia's offer price how many preferred shares must Preview Travel offer to OuadMedia to raise $7.5 million? At this price, what fraction of Preview Travel's equity would QuadMedia own? How much of Preview Travel's equity were Hornthal and Orton hoping to sell to raise $7.5 million?

d) Construct a discounted cash flow model to value Preview Travel's equity as of late 1997. To do so, make the following simplifying assumptions:

   - 1998 revenues equal $19 million (as stated on p. 13);
   - 36 % annual growth in revenues from 1998 through year "n";
   - 6% annual growth in revenues beginning in year "n+1" and continuing in perpetuity;
   - Profit margin after tax on sales equal to –30% in 1998, -15% in 1999, 0% in 2000, and 10% thereafter;
   - Cash flow to equity can be approximated by net income;
   - The required rate of return on equity is 18%.

   What value of "n" in your discounted cash flow model is consistent with QuadMedia's offer to pay $4.50 per share of preferred stock in late 1997? Based on your answer, do you think QuadMedia's offer is low, high, or just right?

e) Consider Hambrecht & Quist's proposal that Preview Travel go public via an initial public offering of its shares. Why might Hambrecht & Quist's proposal that Preview Travel do an IPO be attractive? What risks does a decision to go public pose for Preview Travel?

f) Consider the valuation model you constructed in response to question (d) above. Presuming that Hambrecht & Quist have made similar assumptions about the firm's earnings through 2001, what does its valuation imply about how long Preview Travel's earnings will grow at 36% per year? In other words, what value of "n" is consistent with the Hambrech & Quist's valuation?

g) In addition to discounted cash flow models, another way to value private companies is to consider the prices at which comparable public firms trade. For example, if comparable public companies trade at, say, 2 times revenue, we might conclude that Preview could command the same multiple. Use the data in Exhibit 7 to estimate a value of Preview Travel's equity. How does this value compare with your discounted cash flow valuations? Under what circumstances will a multiple-of-revenues, or a multiple-of-earnings, model yield a useful estimate of value?

h) What should Preview Travel do?

22. Friday, May 25 – **The Market for Initial Public Offerings**

Prepare: <u>Preview Travel (A)</u> (continued)

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

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

a) Why was Gulf attacked? What are the sources of value bidders hope to reap from the acquisition of Gulf?

b) Assess the performance of Gulf's management in running the company. Does Gulf's exploration program appear economically viable?

c) How much is Gulf worth per share to Socal? How much are competing bidders likely to bid? How much should Mr. Keller bid?

d) Assess Mr. Lee's response to the attack on Gulf. What should he do now?

e) Who are the winners and losers in takeover battles such as this? Are the many takeover bids and restructurings good for the oil industry?

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

Prepare: <u>Gulf Oil Corporation – Takeover</u> (continued)

25. Friday, June 8 – **Bankruptcy Mechanics**

Prepare for submission Application Exercise 5, Resource Allocation Decisions.

Read:

a) "Note on Bankruptcy in the United States" Harvard Business School, N9-294-068

b) Weiss, Lawrence, "The Bankruptcy Code and Violations of Absolute Priority," *Journal of Applied Corporate Finance*, Spring, 1991, pp. 7 – 18.

Prepare: <u>National Convenience Stores</u>

a) What pushed NCS into Chapter 11? Was it just bad luck, or was there more involved?

b) What are the creditor-claims against NCS? What are the claims of each creditor class?

c) Should NCS be reorganized or liquidated? If liquidated, how would the cash be distributed?

d) What is management's operating plan? What do you think of the plan?

e) What is a reorganized NCS worth?

f) How should the reorganized company be capitalized?

26. Friday, June 8 – **Reorganization in Bankruptcy**

Prepare: National Convenience Stores (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?