

UNIVERSITY OF WASHINGTON
Problems in Corporate Planning and Financing
Finance 552
Fall 2008

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Office Hours: Wednesdays, 9:30-11:30 a.m., also by appt.
Course materials available on Blackboard, <http://uwbs.blackboard.com>

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 principle 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 in Long-Term Financing

The first part of the course examines financial management of short-term operations and the cash flowing through the business. The second and third 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 new venture funding, leasing, project finance, securitization, 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 convertible securities, project finance, leases, and private equity financing.
- 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. So please participate actively.

So what is conscientious case preparation? Read the case thoroughly; identify principle 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 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 class on the day we discuss the case. For the first writeup, you may choose any case in the course syllabus assigned for the first section of the material, 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 of the material, Optimal Capital Structure and Long-Term Financing (sessions 7 through 11). The third and fourth writeups should be cases in the third section, Special Topics in Long-Term Financing. The third writeup should be one of the cases in class sessions 12-15, and the fourth writeup should be one of the cases in sessions 16-19.

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 Sept. 26. 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 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 Tuesday, Dec. 2, and your writeup will be due on Monday, Dec. 8 at noon.

MATERIALS:

The following materials are required for this course:

- Packet of Cases (University Readers, www.universityreaders.com)
- **Robert C. Higgins**, *Analysis for Financial Management* (Eighth Edition), Irwin/McGraw-Hill, 2007.

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* (First Edition), Pearson Education, 2007.
- **Richard A. Brealey, Stewart C. Myers and Franklin Allen**, *Principles of Corporate Finance* (Ninth Edition), McGraw Hill, 2008.

Course Schedule

SHORT-TERM FINANCIAL ANALYSIS AND PLANNING

Class 1 (Thursday, Sept. 25): Determinants of Financial Structure

Prepare (in class): The Case of the Unidentified Industries- 2006

- a.) Working in class, in teams, see how well you can match company financial data to differing industries.

Class 2 (Tuesday, Sept. 30): Assessing the Financial Health of the Firm

Read: Higgins, Chapter 2.

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

- a.) What was Wal-Mart's return on equity in 1997? What was Sear's return on equity that year? 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? (Note: Be careful about the different fiscal year-ends for the two companies.)
- b.) What are the determinants of ROE?
- 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 (Thursday, Oct. 2): Financial Forecasting and Cash Budgeting

Read: Higgins, Chapter 3

Prepare: Cartwright Lumber Company

- a.) Why has Cartwright Lumber borrowed increasing amounts despite its consistent profitability?
- b.) How has Mr. Cartwright met the financing needs of the company during the last few years? Has the financial strength of Cartwright improved or deteriorated?
- c.) How much money will Cartwright need? For how long, a few months or longer?
- d.) As a banker, would you approve Mr. Cartwright's loan request, and if so, what conditions would you put on the loan?

Class 4 (Tuesday, Oct. 7): Managing Working Capital

Read: Higgins, Chapter 4

Prepare: Dell's Working Capital

- a.) To what extent was Dell's working capital policy a competitive advantage? How?
- b.) How did Dell fund its 52% growth in 1996? Create a cash flow statement to identify Dell's major sources and uses.
- c.) Assuming Dell sales will grow 50% in 1997, would the company be able fund to this growth internally? Why or why not?

Class 5 (Thursday, Oct. 9): Financing Seasonal Operations

Prepare: Toy World, Inc.

- a.) What factors could Mr. McClintock consider in deciding whether or not to adopt the level production plan?
- b.) What types of savings would be involved?
- c.) What effect will shifting to level production have on the company's need for a bank loan? How would you go about estimating the change in funds required and the timing of the needs under level production?
- d.) Prepare a financial forecast to estimate the company's funding needs with level production. For simplicity assume that interest income and expense do not change with the switch to level production.
- e.) Do you think it is feasible for Toy World to switch to level production? How does the change in funding requirements affect the risk assumed by the various parties?
- f.) What do you think Mr. McClintock should do?

Class 6 (Tuesday, Oct. 14): Cash Flows in a Growth Firm

Prepare: ServerVault: "Reliable, Secure, and Wicked Fast"

- a.) Prepare a forecast of ServerVault's Statement of Cash Flows for the 30 months starting July 2000 and ending December 2002.
- b.) Using your forecasting model, determine the required cash investment in July 2000. How long will a cash investment of as little as \$5 million or as much as \$15 million permit the firm to have a positive cash balance?
- c.) Should ServerVault build a new facility? Analyze the tradeoffs of this decision.
- d.) If ServerVault decides to build a new facility, what are the key drivers of its success?

OPTIMAL CAPITAL STRUCTURE AND LONG-TERM FINANCING

Class 7 (Thursday, Oct. 16): Long-Term Financing Alternatives

Read: Higgins, Chapter 5, pp. 149-162.

Prepare: National Gypsum Products Corporation

- a.) What are the advantages and disadvantages of the three methods NGP might use to raise the needed external capital?
- b.) Appraise the arguments of the various directors. As Mr. Sanford, how would you respond to the arguments raised by the directors?
- c.) Estimate NGP's 2006 leverage ratio (D/D+E) and coverage ratio under the three alternatives.
- d.) Which of the financing methods do you recommend? Why?

Class 8 (Tuesday, Oct. 21): Target Capital Structure- Changing Debt Policy

Read: Higgins, Chapter 6, pp. 197-209.

Prepare: Debt Policy at UST Inc.

- a.) What are the primary business risks associated with UST Inc.? What are the primary attributes of UST Inc.? Evaluate from the viewpoint of a bondholder.
- b.) Why is UST Inc. considering such a dramatic change to their target capital structure after such a long history of conservative debt policy?
- c.) Calculate the marginal effect of the interest tax shield from the \$1 billion in debt on UST's value, assuming that:
 - i.) the entire change in capital structure is implemented immediately (Jan. 1, 1999)
 - ii.) the tax rate is 38%
 - iii.) the \$1 billion in new debt is constant and perpetual.
- d.) What will be the likely bond rating on the new debt? Why?
- e.) UST Inc. has paid uninterrupted dividends since 1912. Will the change in capital structure hamper future dividend payments?
- f.) Should UST implement the change in debt policy?

Class 9 (Thursday, Oct. 23): Target Capital Structure – Changing Debt Policy

Read: Higgins, pp. 210-231.

Prepare: Bed, Bath & Beyond: The Capital Structure Decision

- a.) How would you characterize the business risk of Bed, Bath & Beyond?
- b.) What tax savings will accrue to the company if it increases financial leverage? How will the added leverage affect EPS?
- c.) How will the added leverage affect the company's probability of bankruptcy? What will the company's interest coverage be with the increased leverage? Is this adequate?
- d.) What message would the decision to increase leverage send to the capital markets?
- e.) What should Bed, Bath & Beyond do? Why?

Class 10 (Tuesday, Oct. 28): Target Capital Structure- Leveraged Recapitalizations

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

- a.) Why did Sealed Air undertake a leveraged recapitalization? How will the transaction affect leverage ratios and EPS?
- a.) What other changes are happening at Sealed Air during this period? How are these changes related?
- b.) What are the alternative uses of excess cash? Why did Sealed Air choose an extraordinary dividend rather than a share repurchase of comparable size?
- c.) Did the deal create value for shareholders? How would you measure any value impact?
- e.) Why did Sealed Air's investor base turnover completely after the recap? Is this something managers should be concerned about?
- f.) 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?

(*) If you choose to use this case for your group writeup, take the perspective of a research analyst at the end of 1989. In addition to the above questions, would you recommend that investors buy the stock?

Class 11 (Thursday, Oct. 30): Target Capital Structure- Tradeoff Theory

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?
- 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 advantages and disadvantages of more debt for them?
- d.) Should Diageo change its target capital structure?

SPECIAL TOPICS IN LONG-TERM FINANCING

Class 12 (Tuesday, Nov. 4): New Venture Financing

Read: Higgins, Chapter 5, pp. 163-176.

Prepare: Conor Medsystems

- a.) What business decisions is Conor Medsystems facing? How will these issues affect its funding needs?
- b.) How has Conor financed its growth so far?
- c.) What are the current funding needs? For what purposes will the capital be used?
- d.) What are the alternative sources of capital for the new funding round? What are the advantages and disadvantages of each?

- e.) How should Litvack structure this round of funding?

Class 13 (Thursday, Nov. 6): Convertible Securities

Read: Higgins, Appendix to Chapter 5

Prepare: Corning: Convertible Preferred Stock

- a.) How has Corning performed since 2000?
b.) How has Corning raised capital in the past? Why does the firm need to raise capital now?
c.) Work through the following example. What does the example suggest about the difficulty/desirability of raising equity?

Suppose that the face value of Corning debt is \$4 billion and that the value of its assets will either be \$10 billion (to creditors and shareholders) or \$2 billion (to creditors in bankruptcy), with equal probability. Compute the market value of debt and the market value of equity per share, ignoring discounting. What happens to the market value of equity per share if Corning raises \$400 million in equity and invests the proceeds in projects that deliver \$500 million in value for certain, i.e., regardless of the value of the rest of Corning's assets?

- d.) Why do you think JP Morgan is proposing this particular security? Who are the likely buyers?
e.) What are the risks of this offering for Corning?
f.) What should Flaws do?

Class 14 (Tuesday, Nov. 11): CLASS CANCELLED: Veteran's Day Holiday

Class 15 (Thursday, Nov. 13): Project Finance

Prepare: Petrolera Zuata, Petrozuata C.A.

- a.) What are the costs and benefits of using project finance instead of traditional 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?

Class 16 (Tuesday, Nov. 18): Securitization

Read: Accounting for Asset-Backed Securitization

Prepare: Fraikin S.A.

- a.) What are the possible advantages of securitized lending relative to more conventional forms of lending? Why does securitized lending appear to carry a lower interest rate than more conventional loans?
- b.) How does a whole business securitization differ from a more conventional securitization? Are these differences important to Fraikin?
- c.) What is “ring fencing?” How important is effective ring fencing to the viability of Fraikin’s proposed securitized financing? Why?
- d.) Using the company’s 2003 balance sheet, how would Fraikin’s debt-to-total capital employed ratio change if the company raised €400 million by securitizing €500 million of its equipment for lease? What does this say about Fraikin’s creditworthiness after the securitization relative to before?
- e.) From Fraikin’s perspective, what are the principal strengths and weaknesses of the three financing alternatives described in the case? On balance, which of the three alternatives should Fraikin use? Why?

Class 17 (Thursday, Nov. 20): Financial Distress and Bankruptcy

Prepare: The Loewen Group, Inc. (Abridged)

- a.) What has been Loewen’s business strategy been in recent years? How has Loewen supported this strategy? In the years 1990-1998, what was Loewen Group’s annual sustainable growth rate? What sustainable growth challenges did the company face during this period? How did it address these challenges?
- b.) What is Loewen’s target capital structure? How levered was Loewen, and how close to its target? As part of your response to this question, estimate the tax benefits of debt for Loewen.
- c.) By 1999, Loewen is apparently in trouble. How serious is the situation? Why? What are its immediate cash flow needs?
- d.) Did Loewen’s distress result primarily from operating or financial decisions? Was the distress primarily the result of external factors, such as economic conditions, or internal factors, such as management decisions?
- e.) How costly do you think financial distress is apt to be to Loewen? In your answer please consider the effects of distress on the company’s customers, acquisition targets, and lenders, as well as any other effects you think are relevant.
- f.) What alternatives are available to Loewen now? What are the primary advantages and disadvantages of these alternatives? Which option do you recommend, and why?

Class 18 (Tuesday, Nov. 25): Financial Distress and Bankruptcy

Prepare: Williams, 2002

- a.) Evaluate the terms of the proposed \$900 million financing. What is the purpose of each of the terms of the proposed financing? What major problems are the terms attempting to solve?
- b.) How would you estimate the return to investors in this transaction? How does the overall return to Berkshire Hathaway and Lehman look relative to the risks they must assume?
- c.) How much money does Williams need? To address this question, estimate their cash flows for the second half of 2002.
- d.) How did Williams get into this situation? Is their distress primarily the result of operating or financial decisions?
- e.) What are Williams' options? Are there any alternatives to the proposed deal? What are the major advantages and disadvantages of these various choices?
- f.) Do you recommend accepting the proposed \$900 million financing offer? If so, why? If not, what alternative do you recommend, and why?

Class 19 (Tuesday, Dec. 2): Payout Policy

Prepare: Dividend Policy at Linear Technology

- a.) Describe Linear Technology's payout policy.
- b.) What are Linear's financing needs? Would a quarterly dividend of 6 cents a share be a problem for Linear?
- c.) If Linear were to pay out its entire cash balance as a special dividend, what would be the effect on value? On the share price? On earnings? On earnings per share? What if Linear repurchased shares instead? Assume a 3% rate of interest on any cash balance.
- d.) Why do firms pay dividends? Why has the rate of dividend initiations changed over time?
- e.) What should Paul Coghlan recommend to the board?

Class 20 (Thursday, Dec. 4): Summary and Course Overview