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Course Description
Corporate Financial Policies (FIN 8423) Q3 2011

Corporate Financial Policies (CFP) extends the corporate finance topics that were introduced in First-Year Finance and then enhanced in the Valuation course. The viewpoint of the course is predominantly that of the chief executive office, chief financial officer and treasurer of a corporation. The objective of the course is to become familiar with the various aspects normally attributed to a CFO's job. Topics include: risk management, resource allocation, dividend policy, raising external funds, determination of the cost of capital, evaluating investment opportunities and the design of management.

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Course Pack: All required class materials (except those marked To Be Distributed (TBD)) are provided in the *Course Pack.*

Class Portal 8423: The Class Portal provides a number of useful resources for the class. If the materials required for the class are Darden copyrighted materials, you will find PDF copies of them on the portal. The portal also contains the student Excel files. Due to copyright issues, other materials are either provided as a URL address or are available only through the Course Pack.

Pre-requisites: *Valuation in Financial Markets* is a pre-requisite for the class.

Grade: The grade in the class will be based on class participation and preparation (40%) and a take-home exam (60%).

Class participation: I use cold-calls on a regular basis. Your attendance and participation are essential ingredients to a successful class and for that reason attendance will be monitored. Absence from more than three classes, without extenuating circumstances (e.g., illness, family emergency) will adversely affect your grade. Please call or email me to explain absences.

Course Administration: Students are required to have access to the Brealey, Myers and Allen textbook from which some required and optional readings will be assigned.

Required Textbook

Brealey, Myers and Allen, *Principles of Corporate Finance* (9^{th} ed. 2008) McGraw-Hill/Irwin.

Supplemental Textbook (not required)

Robert Higgins, *Analysis for Financial Management*, (9^{th} ed.) Irwin,

Corporate Financial Policies

Class Summary

1	Wednesday, Jan 19	Kota Fibres	Working Capital Management
2	Thursday, Jan 20	Centennial Pharma Corp	DCF, Management Compensation
3	Wednesday, Jan 26	DSC Communications	Corporate Credit : Note on Bank Loans
4	Thursday, Jan 27	DSC-II	Corporate Credit
5	Thursday, Feb 03	Aurora Textile	Capital Investment in a Troubled Industry
6	Friday, Feb 04	Flagstar Companies	Prepackage Bankruptcy
7	Wednesday, Feb 09	Delphi	Bankruptcy/restructuring
8	Thursday, Feb 10	Diva Shoes	Hedging: Futures and Options
9	Friday, Feb 11	J&L Railroad	Corporate Risk Management
10	Wednesday, Feb 16	Delta Beverage	Hedging
11	Thursday, Feb 17	ERM at Hydro One	Enterprise Risk Management
12	Wednesday, Feb 23	Victoria Chemicals (B)	Capital Investment Analysis/Real Options
13	Thursday, Feb 24	Timken Company	Acquisition and Financing
14	Thursday, March 03	WLR & Tyson	Merger
15	Friday, March 04	White Mathews	A CFO’s view of the job.

Working Capital Management (Financial planning)

Class 1—Jan 19, 2011
Materials: **Kota Fibres, Ltd. (UVA-F-1359)**
File: Kota Fibres (with Level Production).xls

Study Questions:

1. Using the financial forecasts and assumptions provided in Exhibits 10 and 11, describe and calculate the "cash cycle" of the firm (i.e., the flow of funds through the working capital accounts of the firm, expressed in days).
2. Based upon the exhibits given in the case, how much debt will Kota need to arrange for the upcoming year? Will Kota be able to repay the line of credit this year?
3. Why do Kota's financial funding requirements vary throughout the year? What are the key determinants of Kota's borrowing needs?
4. Why does the bank require a 30-day "clean-up" of the loan? Should the bank continue to waive compliance with this covenant?
5. Consider the four memos that Pundir received. Based on your intuition, how will each of these likely affect Kota's borrowing needs?
6. Study the worksheet in Kota Fibres (with Level Production).xls related to the Level Production proposal and be prepared to explain why the average level of borrowing increases and yet the maximum amount of borrowing is reduced.
7. Are there other strategies that should be considered? How viable are these other strategies within the context of the competitive landscape?

Background Reading:

- "Freeing Up the Cash in Your Business," *Growing Your Business*, September/October 2002, PriceWaterhouseCoopers (Required)

Discounted Cash Flow and Management Compensation

Class 2—Jan 20, 2011
Materials: **Centennial Pharmaceutical Corp (UVA-F-1446)**

1. With three years left on the original EP, what would you estimate as the present value of the future bonus payments? Please assume that the 100% level for each bonus payment is expected to be paid each year for the remaining three years of the EP (years 2, 3 and 4). Also assume that earnings for year 2 are high enough to invoke the MBS and please use the 3-year Treasury rate as the discount rate.

2. What would you estimate as the present value of the future payments under the revised EP? Again you should use a the 3-year Treasury rate for all the cash flows and assume that earnings will exceed the 100 percent target level for each year. How does this number compare to your estimate from question 2?

3. How would your answer to question 1 change if the MBS effect occurred in year 4 rather than year 2?

4. Should the guaranteed cash flows be discounted at the same rate as the bonus payments? What discount rate would you recommend for the guarantee payments? What discount rate would you recommend for the bonus payments?

5. How would your present value calculations change for questions 1 and 2 if you used a 12.34% discount rate for the bonus payments and a 7.34% discount rate for the guaranteed payments? What arguments can you make to justify using two different discount rates?

6. As a CloneTech manager, would you vote to accept the revised EP as a “good faith adjustment” to the original EP or not? Please present a brief list of your reasons for your decision.

Working Capital Management (Corporate borrowing decision)

<u>Class 3—Jan 26, 2011</u>
Materials: **DSC Communications (UVA-F-1071)**
File: DSC.xls

Please conduct all of your analysis from the bank's perspective for today's class. As a corporate manager, thinking about issues from the bank's viewpoint can help you learn how to manage the relationship.

Study Questions:

1. Redo Exhibit 7 to reflect how the bank might project DSC's future income statements and balance sheets. Be ready to defend each of the assumptions you use and be particularly aware of the assumptions that are key to the working-capital facility balance. Under what circumstances will the $120 million line be exhausted before 1995? What other sources of funds are assumed will be available?

2. What are the major industry risks faced by the banks that choose to participate in the working capital facility? What are the major company-specific risks faced by the participating banks?

3. How would you structure the new loan to mitigate the risks that you have identified? Think about the following variables when structuring the loan: interest rate, maturity, and covenants (minimum interest coverage, minimum tangible net worth, maximum debt-to-equity, restrictions on dividend payments, etc.)

4. Under what circumstances, if any, would you recommend that SouthBank bid for the loan?

Background Reading:

- Note on Bank Loans (HBS 9-291-026) (Required – old material, but still works!)
- Brealey, Myers, and Allen Ch 31 – Section 5: pp 865-72 (Supplemental/not required: if you want to see how BMA treat these issues.)

Working Capital Management (Corporate borrowing decision)

<u>Class 4—Jan 27, 2011</u>
Materials: **DSC Communications (UVA-F-1071)**
File: DSC.xls

We will continue discussion of DSC based on yesterday's class.

Capital Investment Analysis

Class 5 —Feb 3, 2011
Materials: **Aurora Textile (UVA-F-1536)**
File: Aurora.xlsx

Study Questions:

1. How has Aurora Textile performed over the past 4 years? Be prepared to provide financial ratios that present a clear picture of Aurora's financial condition.

2. List the factors affecting the textile industry. What do you think is the state of the industry in the U.S.? How should you incorporate the state of the textile industry into your analysis? Why should anyone invest money in the industry?

3. What are the relevant cash flows for the Zinser investment? Using a 10% WACC, what do you get as the NPV for the project? What are the value drivers in your analysis? (Hint: for a replacement decision, analysts often find it helpful to prepare two sets of cash flows and two NPVs: one for status quo and one for the new machine.)

4. Craft a memo to the board of directors stating your recommendation about investing in the new Zinser machine. Part of your memo should explain why it is better to invest in the Zinser or to pay a dividend to the shareholders. Be sure to explain the primary reasons that justify your recommended course of action.

Bankruptcy

Class 6—Feb 9, 2011
Materials: **Delphi Corporation (UVA-F-1617)**
File: Delphi.xls

Study Questions:

1. Why didn't Delphi management negotiate a reorganization with the various claimants instead of choosing to go into bankruptcy? Why did they choose Chapter 11 instead of Chapter 7?

2. Explain DIP financing.

3. Would you vote for the POR (Plan of Reorganization) as an equity holder, a secured bondholder, an unsecured creditor, GM?

4. How important is the valuation of Delphi to your vote as an equity holder, a secured bondholder, an unsecured creditor, GM?

5. Why would new equity investors be interested in investing in Delphi?

Background Reading:

- A Managerial Primer on the US Bankruptcy Code" UVA-QA-0633 (Required)
- Note on Bankruptcy in the United States (HBS 9-292-062) (Required)

Bankruptcy

Class 7—Feb 4, 2011
Materials: **Flagstar Companies, Inc (HBS 9-299-038)**
File: Flagstar_Companies.xls

Study Questions:

1. How serious are Flagstar's problems? Would you characterize its problems as being operating performance/strategy, or as financial? Why didn't KKR's recapitalization succeed?

2. Why did Flagstar acquire Coco's and Carrow's only months before Flagstar began discussing a debt restructuring with DLJ?

3. Was a prepackaged Chapter 11 filing the best approach for dealing with the company's problems, or would the company have been better restructured as a negotiated out-of-court restructuring or as a conventional ("free fall") Chapter 11 bankruptcy?

4. Donaldson, Lufkin & Jenrette and Jefferies both offered estimates of Flagstar's enterprise value.
    a. Which bank's valuation analysis is most persuasive in your view?
    b. What are the specific merits and shortcomings of each bank's approach?

5. What mechanisms or approaches are available in Chapter 11 for resolving disputes over enterprise value when the parties are so far apart?

6. Other than disputes over enterprise value, what other complaints do the junior creditors have? Do you see any merit in them?

Risk Management (Hedging)

Class 8—Feb 10, 2011
Materials: **Diva Shoes, Inc. (UVA-F-1222)**
File: Diva Shoes.xls

1. Show your estimate of Diva's projected profits for the fiscal year ending September 1995. Be sure to explain your assumptions.

2. How would you quantify Diva's exposure to exchange rate risk in April 1995? Show your calculations.

3. Assume you have a forward contract available at the forward price implied by interest rate parity (IRP) for September 1995. Also assume that you can buy a put or call at any strike price with a maturity of September 1995. Assume the forward contract carries an all-in upfront cost of 0.5% of the total contracted amount. What do you estimate as the cost of an option with a strike price exactly equal to the IRP forward price?

4. What would you recommend to Mr. Bisno regarding a hedging strategy for foreign exchange? Why?

Background Reading:

- Brealey, Myers, and Allen Ch 28 – Sections 1-3 (Required)

Risk Management (Hedging)

Class 9—Feb 11, 2011

Materials: J&L Railroad: The Board Meeting (UVA-F-1065)
J&L Railroad (UVA-F-1053)

File: J&L Board Meeting.xlsx, J&L Railroad.xlsx

[You may recall J&L was used in FMP. Please read F-1053 as background information and then focus on F-1065 -(The Board Meeting) to answer the study questions below.]

Study Questions:

1. Did Matthews do a good job of summarizing the pros and cons of using NYMEX contracts versus using the risk-management products offered by KCNB?
2. Using the Black-Scholes model as adapted for futures contracts (see Hint1 below), what inputs should you use to price the caps and floors? Be prepared to explain your choice for each variable with particular attention to your estimate of volatility. How do your prices compare to KCNB's quotes? What would explain the pricing differences relative to NYMEX options?

   Hint 1: To price an option on a futures contract, the Black-Scholes model uses the futures price as the underlying asset, and the dividend yield is set to the risk-free rate.

   Hint 2: Recall that KCNB products are priced on the average heating-oil price. Thus, your estimate of the underlying asset price should be the expected average heating-oil price for the next 12 months.

3. How could KCNB make money on the J&L hedges? How would KCNB hedge its side of the contract (i.e., how would the bank offset the exposure created by selling its average price products using NYMEX futures and options)?
4. How should Matthews adjust the accounting records for the commodity swap?
5. What could Matthews do to protect herself from criticism of her proposal while retaining credit for being the champion of hedging?

Background Reading:

- "A Framework for Risk Management," Froot, Scharfstein, and Stein. *HBR Reprint 94604* (Required)

Risk Management (Hedging)

Class 10—Feb 16, 2011
Materials: **Delta Beverage (UVA-F-1188)**
File: Delta.xls

Study Questions:

1. Starting with Bierbaum's estimate of a 4.0% increase in net revenues, compute Delta's expected operating profits for the next 12 months. How sensitive are these profits to a 5% increase in the cost of aluminum cans. 10% increase? Perform the same estimates for Delta's exposure to PET containers and fructose.

2. Based on your sensitivity analyses, is Delta in jeopardy of violating its interest coverage ratio covenant as presented in Exhibit 5? (Use 1993 cash interest expense to compute the ratios.)

3. Should John Bierbaum hedge Delta's exposure to aluminum in July 1994? Should he be concerned about reducing Delta Beverage's leverage?

4. Assume for the moment that Bierbaum has decided to hedge against aluminum price increases going forward. Design a specific hedging strategy that specifies the amount of aluminum to hedge and how many futures contracts you would need to accomplish the hedge.

Enterprise Risk Management

Class 11 —Feb 17, 2011
Material: **Risk Management at Hydro One (HBS 9-109-001)**

Study Questions:

1. What is Hydro One's strategy?

2. What are the threats to HO's strategy?

3. Be prepared to discuss Hydro One's enterprise risk management program: the process and the outcome: Exhibits 3-6.

4. What specific actions would you envision for some of the worst case events in Ex 3? For example, what plan would you have in place to react to a major winter storm that left more than 100,000 customers without power with sub zero temperatures?

5. What difference does ERM make to the running of the business, compared to not having a process like this at all?

6. Should Laura Formusa, CEO, change Hydro One's strategic objectives in light of the changes and events in Exhibit 8 and the interviews in Exhibit 9?

Capital Investment Analysis (Real Options)

Class 12— Feb 23, 2011

Materials: **Victoria Chemicals (B) (UVA-F-1544)**
Victoria (A) Revised DCF Analysis Merseyside.pdf (posted on URL)
Victoria Chemicals (A) (UVA-F-1543) (posted on URL as background reading, if needed)

File: Victoria (B).xlsx, Victoria (A) Revised DCF.xlsx

[Victoria (B) is a sequel case to Victoria Chemicals (A), which you studied in FMP. I am including a copy of the A case as background reading, if needed, as well as a pdf and Excel file for the revised DCF of the A case: the Merseyside project. Please use the study questions below to frame your analysis of the B case for this class.]

Study Questions:

1. Why are the Merseyside and Rotterdam projects mutually exclusive?
2. How do the two projects compare on the basis of Victoria Chemicals' investment criteria? What might account for the differences in rankings?
3. Is it possible to quantify the value of *potentially* adding the Japanese technology to the Merseyside project? How, if at all, does this flexibility affect the economic attractiveness of the project?
4. What are the differences in the ways Elizabeth Eustace and Lucy Morris have advocated their respective projects? How might those differences in style have affected the outcome of the decision?
5. Which project should James Fawn propose to the chief executive officer and the board of directors?

Background Reading:

- "Strategy as a Portfolio of Real Options" by Timothy Leuhrman HBR, September-October, 1998 (required)

- "Investment Opportunities as Real Options: Getting Started on the Numbers" by Leuhrman HBR, July-August, 1998 (Supplemental – not required)

Mergers and Acquisitions

Class 13—Feb 24, 2011
Materials: **Timken Company (UVA-F-1472)**
File: Timken.xlsx

Study Questions:

1. How does Torrington fit with The Timken Company? What are the expected synergies?

2. What is your stand-alone valuation of Torrington? Be prepared to explain and justify all the major assumptions used in your estimate.

3. What is your with-synergies valuation of Torrington? Be prepared to explain and justify all the major assumptions used in your estimate.

4. Should Timken be concerned about losing its investment-grade rating? How do Timken's financial ratios compare with those of other industrial firms in 2002? How would those ratios change if Timken borrowed $800 million, for example, to buy Torrington?

5. If Timken decides to go forward with the acquisition, how should Timken offer to structure the deal? Is Ingersoll-Rand likely to want a cash deal or a stock-for-stock deal? What are the risks for Ingersoll-Rand of accepting Timken shares for some or all of the consideration?

Mergers and Acquisitions

<u>Class 14—Mar 3, 2011</u>
Materials: WLR Foods and Tyson Foods (UVA-F-1465)
File: WLR_Tyson.xlsx

Study Questions:

1. What are the business models of WLR Foods and Tyson Foods? What are the major trends in the poultry industry in 1994?
2. How does WLR fit with Tyson Foods? What are the expected synergies?
3. What is your stand-alone valuation of WLR Foods? Be prepared to explain and justify all the major assumptions used in your estimate.
4. What is your with-synergies valuation of WLR Foods? Be prepared to explain and justify all the major assumptions used in your estimate.
5. Given your valuation estimates, what strategy should Tyson take to ensure that the deal gets done? What should Tyson do to persuade the poultry farmers to vote their shares in favor of the deal? Are the farmers being irrational to resist the deal? Is WLR management rational to fight the deal?

Wrap – up (guest speaker)

Class 15—Mar 4, 2011

L. White Matthews, former Executive Vice President, CFO and board member of Union Pacific Corporation and Ecolab will speak to the class today. Mr. Matthews sits on numerous boards and will speak of the challenges he faces as a board member as well as his experiences as a senior manager at UP and Ecolab. To prepare for his presentation, please read the materials distributed prior to the class. The articles below are provided as supplemental reading:

Background Reading:

- "Time for CFOs to step up," Timothy Koller and Jonathan Peacock, *The McKinsey Quarterly*, 2002 Number 2. (Supplemental – not required)
- "You're Not CFO Material: Wondering whether you have what it takes? Here are ten signs that you're never going to make it to the big chair," *CFO Magazine*, April 2003, by Marie Leone (Supplemental – not required)