USC Marshall School of Business

FBE 421 Financial Analysis and Valuation

Syllabus – Fall 2014
Professor: Julia Plotts
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Lecture Class:
Tuesday/Thursday Room: JKP 110
15324 10:00am-11:50am
15325 12:00noon-1:50pm

Office Hours: Before/after class by appointment

Course Description and Topics

This course develops and uses tools of financial and valuation analysis to evaluate the performance and assess the value of companies.

Financial Analysis and Performance Measurement

- What do the numbers mean? We will discuss tools for analyzing company strategy and financial performance.

Value Creation

- Understand that the goal of the firm is value creation. Return on capital and growth drive value creation. Value creation is fundamentally more important than that of growing revenues, earnings per share, maximizing volume and/or market share. Companies and business units create value by investing capital in positive net present value (NPV) projects.

Core Valuation Techniques and Financial Analysis

- There are many approaches to determine fair market value (FMV) of a firm. We will discuss discounted cash flow and comparable companies valuation approaches.
- Gain proficiency in performing discounted cash flow valuation analysis to value a company. This includes analyzing historical performance, benchmarking and strategic analysis and forecasting free cash flows, estimating the appropriate cost of capital, identify sources of value, interpretation of results.
- Analyze market multiples and precedent merger and acquisition transaction analysis to perform the market approach to valuation.

Managing for Value and Using Valuation for Decision Making

- Utilize and interpret financial data and applying valuation techniques to make decisions about courses of action for a firm.
- Discuss methods for creating value through mergers and acquisitions, divestitures and restructuring.
- Discuss valuation of distressed companies and the impact of financial leverage.

Other Valuation Issues and Special Situations

- Explore the challenges of valuing high-growth and private companies.
- Learn about the process of venture capital and early stage financing.
- Discuss leveraged buyouts and the approach to valuing highly leveraged companies.

Course Learning Objectives

This course covers the theory and practice of financial analysis and valuation. Our coverage of the material is designed to allow you to become comfortable with the fundamentals so that you may improve your proficiency in participating in future financial and strategic discussions within a company or organization and with external analysts and service providers. Learning goals include:

1. Understand the key aspects of financial analysis and valuation to effectively manage different types of enterprises. Students will gain knowledge of the following areas: accounting, finance, strategy and industry analysis.
2. Demonstrate critical thinking skills in the application of techniques in financial analysis and valuation. Students will gather, categorize, analyze, interpret, and evaluate relevant qualitative and quantitative information and develop the ability to be creative and innovative through the completion of a final valuation project.
3. Develop communication strategies for discussing financial analysis and valuation. This includes effective oral and written presentations of quantitative and valuation analysis. Conduct research using a broad range of sources, synthesizing and judging the quality of collected information and support written or oral claims logically and persuasively.
4. Apply valuation in a global context, considering the interplay of international markets, and economic, social and cultural issues. Students will consider issues involved in cross-border M&A and valuation analysis.

Required Materials

Textbook: *Investment Banking: Valuation, Leveraged Buyouts, and Mergers & Acquisitions* by Rosenbaum and Pearl. 2nd edition. Published by Wiley ISBN-13: 978-1118656211

Cases: The course pack with our three cases can be purchased online at the following link (each case is $3.95): https://cb.hbsp.harvard.edu/cbmp/access/28353791

Course Notes

Slides, handouts and supplemental readings/articles will be posted on Blackboard. Notes or recordings made by students based on a university class or lecture may only be made for purposes of individual or group study, or for other non-commercial purposes that reasonably arise from the student's membership in the class or attendance at the university. This restriction also applies to any information distributed, disseminated or in any way displayed for use in relationship to the class, whether obtained in class, via email or otherwise on the Internet, or via any other medium. Actions in violation of this policy constitute a violation of the Student Conduct Code, and may subject an individual or entity to university discipline and/or legal proceedings.

Recommended Reading

The Wall Street Journal, *The Economist*, *Barron's*, *Forbes* (available through http://mymarshall.usc.edu or Crocker Business Library). Wall Street Journal student subscription rates are available: http://wsjstudent.com

Prerequisite Knowledge
This course assumes that the background knowledge of students include basic finance (BUAD 306) and accounting. It will be assumed that students are comfortable with the topics of standard corporate finance texts such as Ross, Westerfield and Jaffe or Brealey & Myers. Please review your basic finance and accounting concepts. The pace and schedule of topics covered in this class does not allow for review of these concepts.

Class Participation
Please arrive to class on time and prepared. Be prepared for cold calling, bring your name card to class. Please handle mobile phone and text messaging outside of class and perform unrelated web browsing outside of class. Please come to class rested (if you sleep in class you will be asked to leave).

Grading Policies
Final grades represent how you perform in the class relative to other students. Historically, the average grade target for this class is a 3.3/4 (B+). Three items are considered when assigning final grades: 1) your average weighted score as a percentage of the available points for all assignments (the points you receive divided by the number of points possible) 2) the overall average percentage score within the class 3) your ranking among all students in the class.

	Grade Breakdown
Assignment/Case Analysis and Participation	20%
Group Peer Evaluation	5%
Final Group Valuation Project	25%
Midterm 1 Exam:	25%
Midterm 2 Exam:	25%
Total	100%

Class Participation
High Score:

- Regular attendance and active and consistent participation in the class sessions with insightful questions and comments.
- Consistently very high levels of preparation for class sessions and activities.
- Superior and sophisticated understanding, insights, and syntheses of the course material as reflected in group assignments and case analysis and class discussions.
- Proactive and very high levels of involvement in the group assignments.
- Very high levels of professionalism manifested in interactions with speakers and classmates.

Case Analysis
We will analyze real companies and work through problems by analyzing different scenarios and courses of action. In your analysis of our HBS case studies you should place yourself in the role of the decision maker as you read through the situation and identify the problems and issues. The next step is to perform the necessary analysis. To get the most out of cases, you should read and reflect on the case individually, and then meet in study group teams prior to class to “warm up” and discuss your findings with other classmates. In class we will probe underlying issues, compare different alternatives, and finally, suggest courses of action in light of the objectives of the case.

The cases have been included in the curriculum as a means to provide this self-study and practice in analysis. Study groups should prepare and hand-in a pre-session case study analysis at the beginning of class. For most of the HBS cases you will receive supplementary excel spreadsheets via Blackboard.

All cases are used as a means to assess class participation assessment. Your group case analysis will be turned in as a written deliverable. Please work on your cases in groups of 3-6 people. Do your best to work through the case utilizing readings and other supporting materials. Seeking assistance or "hints" from the instructor, the T.A. or past students is not authorized. A written case analysis should consist of a 2-4 page written (executive summary) using a standard font and font size (such as Times New Roman size 11-12), addressing the case questions with supporting computations and tables in a separate appendix (if relevant).

Assignment and case grading is based on the quality of your analysis, how well you support your assumptions and apply valuation techniques, and the judgment you exercise and on the professionalism of your presentations. The quality of work product should be reflective of what you would be comfortable presenting to a current or prospective employer. Case grades will be determined relative to the analyses of other groups in the class. Groups will be randomly selected to verbally present their findings on *both* the graded and discussion cases during the class session.

Assignment/Case Submission Policy
Assignments must be turned in on the due date/time electronically via Blackboard. Any assignment turned in late, even if by only a few minutes, will receive a grade deduction (for example, if your work is a B+ grade, you will be given a C+ grade). If your Internet breaks down on the due date, you must deliver a hard copy at the beginning of class on that day. If you are unable to attend class on that day, make arrangements for it to be delivered to the classroom or to my box by the start of class. Late or not, however, you must complete all required assignments to pass this course.

Final Valuation Group Project & Peer Evaluation: Work in a group of your choice (3-6 students) on the final valuation project. The cover sheet of each written assignment should contain the first and last names of the students submitting the assignment arranged alphabetically. All of the names of the members in the group must appear at the top of the memo to receive credit. An overview of the final project deliverable will be posted in the "Assignments" section on Blackboard no later than November 8th. You will be asked to present your final case on our Final Exam date, December 11th. Attendance is mandatory. You will also be asked to complete a peer evaluation of each team member, which will be considered in the final grading assessment.

Exams
Students will need a financial calculator capable of performing discounted cash flows, IRR and other financial calculations. Exam questions will include both qualitative and quantitative questions from material covered in class, and presented in the readings (textbook, cases, examples posted, class discussion). There are no make-up exams. Exams are closed-book, closed-note (no-formula sheets).

Retention of Graded Coursework
Final exams and all other graded work which affected the course grade will be retained for one year after the end of the course ***if*** the graded work has not been returned to the student; i.e., if I returned a graded paper to you, it is your responsibility to file it.

Technology Policy
Laptop and Internet usage is not permitted during academic or professional sessions unless otherwise stated. Use of other personal communication devices, such as cell phones, is considered unprofessional and is not permitted during academic or professional sessions. ANY e-devices (cell phones, PDAs, I-Phones, Blackberries, other texting devices, laptops, I-pods) must be completely turned off during class time. No student may record any lecture, class discussion or meeting with me without my prior express written permission. I reserve all rights, including copyright, to my

lectures, course syllabi and related materials, including summaries, prior exams and all supplementary course materials available to the students enrolled in my class.

Statement for Students with Disabilities

Any student requesting academic accommodations based on a disability is required to register with Disability Services and Programs (DSP) each semester. A letter of verification for approved accommodations can be obtained from DSP. Please be sure the letter is delivered to me as early in the semester as possible. DSP is located in STU 301 and is open 8:30 a.m.–5:00 p.m., Monday through Friday. The phone number for DSP is (213) 740-0776.

Statement on Academic Integrity

USC seeks to maintain an optimal learning environment. General principles of academic honesty include the concept of respect for the intellectual property of others, the expectation that individual work will be submitted unless otherwise allowed by an instructor, and the obligations both to protect one's own academic work from misuse by others as well as to avoid using another's work as one's own. All students are expected to understand and abide by these principles. SCampus, the Student Guidebook, contains the Student Conduct Code in Section 11.00, while the recommended sanctions are located in Appendix A. http://www.usc.edu/dept/publications/SCAMPUS/gov/

Students will be referred to the Office of Student Judicial Affairs and Community Standards for further review, should there be any suspicion of academic dishonesty. The Review process can be found at: http://www.usc.edu/student-affairs/SJACS/ Failure to adhere to the academic conduct standards set forth by these guidelines and our programs will not be tolerated by the USC Marshall community and can lead to dismissal.

Other

The material presented and the classroom discussions are not intended to be financial advice to students in connection with any issue(s) they or others may have. If students have a financial matter, they are advised to promptly consult an experienced professional who can fully review the facts and advise them accordingly.

Schedule	Topics	Readings/Deliverables*
Week 1		
26-Aug	Introduction and Course Overview	Syllabus
28-Aug	Foundations of Value	
Week 2		
2-Sep	Financial Analysis and Performance Measurement	
4-Sep	Financial Analysis and Performance Measurement	Starbucks case (HBS)
Week 3		
9-Sep	Cash Flow Analysis	Supplement Materials on BB
11-Sep	Comparable Companies Analysis	Rosenbaum Pearl Chapter 1
Week 4	**Valuation In Practice**	
16-Sep	Capital Budgeting and WACC Review	Hansson Case (HBS)*
18-Sep	Guest Speaker: Bob Champagne VP, Corporate Financial Planning & Analysis at Starbucks	Supplement Materials on BB
Week 5	**Core Valuation Techniques**	
23-Sep	Precedent Transaction Analysis	Rosenbaum Pearl Chapter 2
25-Sep	Discounted Cash Flow	Rosenbaum Pearl Chapter 3
Week 6	**Core Valuation Techniques**	
30-Sep	Discounted Cash Flow	Rosenbaum Pearl Chapter 3
2-Oct	Gut-Checking Valuation Assumptions	Interco Case (HBS)*
Week 7		
7-Oct	Activist Investors	Home Depot Case
9-Oct	Midterm 1 Exam	
Week 8	**Application of Valuation Analysis**	
14-Oct	Mergers and Acquisitions	Rosenbaum Pearl Chapter 6
16-Oct	Special Topic	
Week 9	**Application of Valuation Analysis**	
21-Oct	Valuing Distressed Companies Guest Speaker: Jeff Raithel	Supplement Materials on BB
23-Oct	Mergers and Acquisitions	Rosenbaum Pearl Chapter 7
Week 10	**Application of Valuation Analysis**	
28-Oct	Private Company Valuation	Spyder Case (HBS)*
30-Oct	Private Equity and LBOs	Rosenbaum Pearl Chapter 4
Week 11	**Application of Valuation Analysis**	
4-Nov	Introduce Final Project	Supplement Materials on BB
6-Nov	Private Equity and LBOs	Rosenbaum Pearl Chapter 5
Week 12	**Application of Valuation Analysis**	
11-Nov	LBO Valuation	Toys "R" Us LBO Case (HBS)*
13-Nov	TBD	
Week 13		
18-Nov	Special Topic	
20-Nov	Midterm 2 Exam	
Week 14		
25-Nov	Guest Speaker: Bob Gatto, Mergers and Acquisitions Nestle	Supplement Materials on BB
27-Nov	Thanksgiving Holiday	
Week 15	**Special Situations**	
2-Dec	Valuing High Growth Companies/VC	The Valuation of Early Stage Companies (HBS)
4-Dec	Course Wrap-Up	
Final Exam	Final Project Presentations and Debrief – Attendance is Mandatory	
Dec 16 (T)	8-10am (10am section), 11am-1pm (12noon section)	

<u>Expansion and Risk at Hansson Private Label Group Case Analysis due September 16th</u>

DCF analysis is a key building block for valuation. In this session we will review the process for applying DCF analysis to a capital budgeting proposal. The case includes a comprehensive forecasting example that focuses on the process one goes through to link production capacity utilization, units sold, unit revenues and unit costs to investment cash flows. This case also reviews the time value of money mechanics of discounting investment cash flows to estimate project value.

We will: 1) introduce the standard financial tools for assessing the attractiveness of a proposed capital investment; 2) discuss the complementing of discounted cash flow analysis with industry analysis; 3) examine issues surrounding capital planning process, especially as it applies to a large investment.

HPL, a manufacturer of private-label personal care products must decide whether to fund an unprecedented expansion of manufacturing capacity.

Discussion Questions:

- Evaluate and comment on HPL's historical performance.
- Utilizing the data provided in the exhibits, determine whether the project is attractive in strategic and economic terms. Calculate the total project cash flows, NPV, and IRR, given the supplied project forecasts. Should Hansson accept or reject the project proposal?
    - *Please submit the group's Excel case analysis.*
- To which key assumptions is the NPV most sensitive? What, if anything, might be done to mitigate the project risks?
- If Hansson wants to decline the expansion proposal, what practical alternative options does he have?

<u>Interco Group Case Analysis due October 2nd</u>

Interco is a company that owned several highly visible branded products, including Converse shoes, London Fog and Ethan Allen furniture. The management of Interco received an unsolicited offer to buy the company from an investor group led by the Rales brothers. The offer involved a substantial premium over the market value of the company, but the management chose to resist the hostile acquisition. As a part of their effort they hired the prestigious investment-banking firm Wasserstein Perella to perform a valuation of the company. The valuation and the methodology are described in the case study.

Interco has been advised by Wasserstein Perella to reject a $70 per share offer for the company. The case deals with the various types of analysis employed by Wasserstein Perella and allows a discussion of the actions of Interco's board as well as Wasserstein Perella.

We will review a third party valuation and introduce the concept of "agency problems". The phrase "agency problems" refers to the potential for conflicts of interest between the shareholders of a public company and its managers (i.e., poor governance). Shareholders will value the cash flows that they actually expect the management will deliver to them in the future. Moreover, managers will not necessarily be interested in pursuing the shareholders' best interests in running a company. As a result, if we are to understand how market values are really determined, we must understand the potential for shareholders' and managers' interests to diverge.

Discussion Questions:

- Consider the summary of the takeover offer in exhibit 9. Was this a fair offer?
- Critique the valuation presented to Interco Board of Directors on August 8, 1988 by advisor Wasserstein, Perella & Co. (exhibits 9-13). In your opinion, were Wasserstein's assumptions reasonable? Were they engaging in M.S.U.? If you disagree with any of the valuation assumptions presented in the exhibits please recreate the valuation and provide explanation and support for your modified assumptions.
- Evaluate the management policies of Interco and assess whether you think the company would be more valuable under current management or under management by the Rales brothers.

<u>Spyder Active Sports Due October 28th</u>
Valuing a Private High-Growth Company
Evaluation of Strategic Alternatives

David Jacobs founded a high-end ski apparel company in 1978. He successfully built and grew the company, establishing a major international brand that appealed to ski racers and other active skiers. In 1995, he sought external financing to support further growth of the company and structured a financial deal with CHB Capital Partners, a private equity firm in Denver. By 2004, Jacobs was ready to consider alternative types of equity transactions that would provide a source of liquidity to him and his family, including sale of Spyder to another apparel company and sale of a large block of stock to a private equity firm.

Case Discussion Questions:
Please note that excel spreadsheets with financial data from the Spyder exhibits are available on Blackboard.

- Identify the different "exit" options that are feasible for Spyder in 2004, and analyze the benefits and costs of each alternative. Is this a good time to sell the business? Consider the interests and needs of the owner(s), the current state and future prospects of the company, and the current state of the financial markets.
- Discounted cash flow valuation: Calculate Spyder's forecasted Free Cash Flow to the Firm using exhibit 5 of the case. Estimate Spyder's terminal value. At what point will Spyder reach the end of its high-growth period? Determine the appropriate discount rate for this analysis. A Discounted Cash Flow (DCF) valuation of Spyder requires assumptions that are not mentioned in the case.
- Spyder is not publicly-traded on a stock exchange, but we can still apply the market approach to estimate the company's implied value (much like we did with UPS's IPO). Evaluate the financial data provided for Spyder and also the comparable publicly-traded company price multiples and comparable past merger and acquisition price multiples.
- Note that the implied value of Spyder via the market approach will be impacted by the type of buyer (strategic or financial) and type of sale (majority/controlling stake vs. minority interest/non-controlling stake). A strategic buyer seeking a controlling stake is an acquirer that might be able to achieve synergies (cost savings) or benefits from the acquisition (and they are typically willing to pay for control). An example might be Nike. A financial buyer is an investor group (like CHB) who would not be able to achieve synergies. They might be looking for an investment that will get them an IRR that compensates them for their investment and for their assistance and expertise as a company grows. They typically are not looking to hold the investment long term, and would ultimately want to exit their investment and harvest a return on investment within a specified period of years.
- Compare the alternative transactions described on the last page of the case. Which one would you choose if you were David Jacobs? Which one would you choose if you were CHB or Shimokubo?

Toys "R" Us LBO Case Due November 11th

The case simulates the experience of a private equity investor evaluating a potential investment, requiring the student to: (1) determine the risks and merits of an investment in Toys "R" Us, (2) evaluate the spectrum of returns using multiple operating model scenarios, and (3) identify strategic actions that might be undertaken to improve the risk/return profile of the investment. The case also discusses trends and participants in the private equity industry.

Case Discussion Questions:
Please note that excel spreadsheets with a template is available on Blackboard.

Your private equity firm has been approached by KKR, Bain and Vornado to join the consortium. You have been asked by a senior member of your firm to prepare a presentation that summarizes the Toys "R" Us investment opportunity. You should:

- Use the provided operating model template to develop assumptions that drive a base case operating model and analyze returns for the group.
  - Use the operating model to generate input for an LBO model, which will calculate relevant returns, financial data, and credit statistics.
  - Focus on developing a reasonable set of projections on which to base your investment recommendation.

- The presentation should include the following:
  - Risks and merits of the transaction
  - Summary of the industry dynamics, including major issues and potential catalysts for improvements
  - A list of key due diligence questions/requests you want to ask Toys "R" Us
  - Summary of debt in the transaction; indicate whether you feel comfortable with the capital structure proposed by the consortium.
  - Downside case(s) that stress test the investment under various difficult outcomes; quantify the risk/return profile of the transaction and evaluate this profile
  - Potential exit opportunities for this investment
  - Recommendation whether or not to join the consortium

  For purposes of your evaluation, assume that you are not able to change the consortium's proposed capital structure.

<u>Final Project Presentations and Debrief</u>
<u>Attendance is Mandatory</u>
Tuesday December 16th
8-10am (10am section)
11am-1pm (12noon section)

The Case Study Topic will be introduced in class on November 4th (Tentative)

Final Deliverable

- Prepare a summary report of your company valuation for the investment committee. The cover sheet of each report should contain the first and last names of the students submitting the assignment arranged alphabetically.
- Groups will be selected at random to present their recommendations (please prepare 5-10 PowerPoint slides with an overview of your valuation and analysis) on the final exam date.
- Provide two printed copies of both your report and your PowerPoint slides on the final exam date. Your instructor will ask you to complete a peer evaluation of each team member, which will be considered in the final grading assessment.

Your final report should include the following:

- Present your concluded value (or range of values) for the company. (A summary "football-field" graph is recommended).
- Discuss your Cost of Capital analysis.
- Discuss your forecast for the company. Specifically, address the key drivers and provide support/rationale for your assumptions.
- Discuss your DCF conclusion and your calculation of the terminal value for the DCF. Indicate which assumptions in the model are the most important drivers of value (which assumptions impact value estimate the most and provide a sensitivity analysis of the value based on these assumptions).
    - Discuss and describe the risks to attainment of your share price target including competition, costs for technology development and deployment, content acquisition, and changing macroeconomic factors.
- Discuss your Market Approach results for the value indication of the target company (Comparable Company Analysis and Precedent Transaction).
    - Discuss any issues related to control and marketability with respect to your selected multiples for the Market Comps and Market Transactions.
- Reconcile the results of your DCF and Market Approaches, i.e., explain your value conclusion based on the indications of value from each approach. Consider issues such: If your value indications differ, is this reasonable? Would this imply the need for any adjustments to your cash flow forecast, WACC, or market multiples, or perhaps the reliance on one approach versus the other? Does your team feel it is more appropriate to weight one valuation method more heavily for your assessment of value?