

Lecture Class:

Day Section 15403

Tues/Thurs 2-3:20pm JKP 110

Office Hours:

Tues-Thurs by appointment

Course Description

This course covers the fundamental theory and practice of corporate financial analysis and valuation. This course will facilitate learning how managers and analysts use financial theory and data to answer questions, solve problems and make decisions. You must become comfortable with the fundamentals to effectively participate in financial and strategic discussions within a company or with external analysts and service providers.

We will develop and use tools of financial analysis to evaluate the performance and assess the value of companies in an industry context. Our approach will rely on both quantitative and qualitative analysis. Our focus will be on developing a rigorous approach that exhibits clarity, accuracy, relevance, completeness and other appropriate intellectual standards. In our analyses we will aspire to be explicit in our purpose, assumptions, conceptual framework, inferences and implications.

Our goals include:

- Understanding the language of financial analysis and valuation
- Seeing the big picture of valuation to understand how things fit together
- Developing facility with the techniques of performance assessment and valuation
- Improving analytic and communication skills, specifically in the context of financial analysis and valuation

Learning Objectives

Following successful completion of the course students will:

Focus on Value Creation

- Understand value creation as a corporate goal. Value creation is fundamentally more important than growing revenues or earnings per share, or maximizing volume and/or market share. Companies and business units create value by investing capital in positive net present value (NPV) projects.

Analyze Financial Statements

- Attain proficiency in financial statement analysis and evaluation of performance metrics. Effectively review and assess a firm's financial statements using performance ratios, historical analysis, strategic analysis and overall competitive assessment of a firm. This includes evaluating the degree to which a firm's financial statements capture the underlying business reality. Recognizing accounting distortions and/or earnings manipulation and restating financials for purposes of analysis.
- Assess long-term earnings and/or cash flow potential by forecasting a firm's financial

performance. This includes assessing firms' future earning potential and financial health (assessing growth, value drivers and risks).

Use Valuation for Decision Making

- Use and interpret financial data and apply valuation techniques to make decisions about courses of action for a firm. Value companies using various valuation models and assess a firm's business and competitive strategy and whether it is creating value for shareholders.

Effectively Communicate a Valuation Perspective or Thesis

- Create and deliver appropriate presentations and written reports that integrate and summarize qualitative and quantitative data and analysis in a format appropriate to a defined audience.

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.

Required Materials

Required textbook: *Valuation – University Edition – Measuring and Managing the Value of Companies*, 5th edition by Koller, Goedhart and Wessels. ISBN 978-0-470-42470-4

We will spend our class time deepening our understanding of the material, clarifying points of confusion, and discussing the material in a contextual way via cases or other “live” examples. This places on you a responsibility to read the assigned material.

Cases: The course pack with our cases can be purchased online at the following link (each case is \$3.95): <https://cb.hbsp.harvard.edu/cbmp/access/32594969>

The materials included are:

1. Costco Wholesale Corporation Financial Statement Analysis (A) and (B)¹
2. Corporate Valuation and Market Multiples²
3. Midland Energy due 2/10/15
4. Lululemon IPO due 2/17/15
5. Spyder Active Sports 2004 due 3/10/15
6. Heinz M&A due 3/24/15

Prerequisite Knowledge

This course assumes that the background knowledge of students include basic finance (GSBA 548) 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. Optional textbook: *Corporate Finance, 3rd edition by Welch*. <http://book.ivo-welch.info/ed3/toc.html> This book is available free online and is an excellent resource to learn or review the foundations of corporate finance.

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

¹ Costco (A) and (B) are discussion cases and do not require a case deliverable.

² *Corporate Valuation and Market Multiples* is a HBS note/reading and does not require a case deliverable.

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 (available through <http://mymarshall.usc.edu> or Crocker Business Library). Wall Street Journal student subscription rates are available: <http://wsjstudent.com>

Class Participation

Please arrive to class on time and prepared. Be prepared for cold calling, bring your name card to class.

Grading Policies

Final grades represent how you perform in the class relative to other students (your z-score will be calculated based on the class average and standard deviation). Historically, the average grade target for this class is a 3.5 (A-/B+).

| | <u>Grade Breakdown</u> |
|--|----------------------------|
| Assignment/Case Analysis and Participation | 20% |
| Group Peer Evaluation | 5% |
| Final Group Valuation Project | 25% |
| Midterm 1 Exam 2/24/15: | 25% |
| Midterm 2 Exam 3/31/15: | 25% |
| Total | <hr/> 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 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 (Midland Energy, Lululemon IPO, Spyder Active Sports, Heinz M&A) 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.

Please work on your cases in groups no larger than 6 people (4-6 recommended). A written case

analysis should consist of a 2-4 page written (executive summary), addressing the case questions with supporting computations and tables in a separate appendix (if relevant). Please submit case deliverables on Blackboard before the start of class on the due date.

The quality of your case analysis should be reflective of what you would be comfortable presenting to a current or prospective employer. Groups may be randomly selected to verbally present their findings on cases during the class session.

Cases will be scored on a 0-1-2 basis:

0 = missing, substantially incomplete, or of very poor quality

1 = partially incomplete or of marginal quality

2 = complete and of good or excellent quality

Many of the case assignments are of an exploratory nature, designed to stimulate your study and thinking about the topic. In this context, quality should not be equated with correctness.

Final Valuation Group Project & Peer Evaluation: Work in a group of your choice (3-6 students) on the final valuation project. An overview of the final project deliverable will be posted in the “Assignments” section on Blackboard. You will be asked to present your final case on our Final Exam date. 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). 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.

Emergency Preparedness/Course Continuity

In case of a declared emergency if travel to campus is not feasible, the *USC Emergency Information* web site (<http://emergency.usc.edu/>) will provide safety and other information, including electronic means by which instructors will conduct class using a combination of Blackboard, teleconferencing, and other technologies.

Academic Conduct

Plagiarism – presenting someone else’s ideas as your own, either verbatim or recast in your own words – is a serious academic offense with serious consequences. Please familiarize yourself with the discussion of plagiarism in *SCampus* in Section 11, *Behavior Violating University Standards* <https://scampus.usc.edu/1100-behavior-violating-university-standards-and-appropriate-sanctions/>. Other forms of academic dishonesty are equally unacceptable. See additional information in *SCampus* and university policies on scientific misconduct, <http://policy.usc.edu/scientific-misconduct/>.

Discrimination, sexual assault, and harassment are not tolerated by the university. You are encouraged to report any incidents to the *Office of Equity and Diversity* <http://equity.usc.edu/> or to the *Department of Public Safety* <http://capsnet.usc.edu/departments/departments-public-safety/online-forms/contact-us>. This is important for the safety of the whole USC community. Another member of the university community – such as a friend, classmate, advisor, or faculty member – can help initiate the report or can initiate the report on behalf of another person. *The Center for Women and Men* <http://www.usc.edu/student-affairs/cwm/> provides 24/7 confidential support, and the sexual assault resource center webpage <https://sarc.usc.edu/reporting-options/> describes reporting options and other resources.

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.

| FBE 529 Spring 2015 Schedule | | | |
|---|--|--------------------|-----------------------|
| Date | Topic | Reading | Deliverable |
| | Foundations of Value | | |
| 13-Jan | Course overview, syllabus review, expectations for the course | Syllabus | |
| 15-Jan | ROIC, Growth and Value Creation | Chapters 1-2 | |
| | Foundations of Value | | |
| 20-Jan | ROIC, Growth and Value Creation continued | | |
| 22-Jan | <i>For Discussion: Foundations of Value exercise</i> | Chapters 4-5 | |
| | Core Valuation Techniques | | |
| 27-Jan | Reorganizing the Financial Statements | Chapter 7 | |
| 29-Jan | <i>For Discussion: Analyzing Performance - Costco (A)</i> | Chapter 8 (skim) | |
| 3-Feb | Forecasting Performance | Chapter 9 | |
| 5-Feb | <i>For Discussion: Forecasting - Costco (B)</i> | | |
| 10-Feb | Cost of Capital | Chapter 11 | <i>Midland Energy</i> |
| 12-Feb | <i>Cost of Capital continued</i> | | |
| | Core Valuation Techniques | | |
| 17-Feb | Discounted Cash Flow Method, Adjustments, Interpretation | Chapters 6, 12, 13 | <i>Lululemon IPO</i> |
| 19-Feb | Methods for Estimating Terminal Value <i>Review Chapter 31 case on Heineken for an integrated example</i> | Chapter 10 | |
| 24-Feb | Midterm 1 Exam | | |
| 26-Feb | TBA | | |
| | Core Valuation Techniques | | |
| 3-Mar | Using Multiples to Triangulate Results | Chapter 14 (skim) | |
| 5-Mar | Corporate Valuation and Market Multiples | HBS Note | |
| | Managing Value | | |
| 10-Mar | Private Company Valuation | Chapter 34 (skim) | <i>Spyder Case</i> |
| 12-Mar | Mergers and Acquisitions | Chapter 21 (skim) | |
| Spring Recess - No Class March 17-19 | | | |
| | Managing Value | | |
| 24-Mar | M&A Private Equity and Activist Perspective | Chapter 21 (skim) | <i>Heinz M&A</i> |
| 26-Mar | M&A continued | | |
| 31-Mar | Midterm 2 Exam | | |
| 2-Apr | TBA | | |
| 7-Apr | Financial Restructuring | See Blackboard | |
| 9-Apr | FR continued | | |
| 14-Apr | Introduce Final Project | | |
| 16-Apr | Final Project continued | | |
| 21-Apr | Special Topic | See Blackboard | |
| 23-Apr | Special Topic | See Blackboard | |
| 28-Apr | Course Wrap-Up | | |
| 30-Apr | Course Wrap-Up | | |
| 2-4pm 7-May | T-Th section 15403: Final Project Presentations | | |

Jan 15-22 for Class Discussion (no deliverable required)
Foundations of Value Exercise

The online article “Creating value: An interactive tutorial” November 2010 <http://tinyurl.com/qd5hdnf> supplements Koller Chapters 1-5 and will assist students who do not yet possess a copy the text. In this video presentation, McKinsey partner Tim Koller explores the four guiding principles of corporate finance that all executives can use to focus on value creation during strategic decisions.

Discussion Questions:

- For application of the concepts discussed in the Foundations of Value Section, please analyze two comparable publicly traded companies to gain familiarity with their business model and strategy. Perform a quick financial analysis and review any trends in performance. Consider financial metrics such as ROE, ROIC, growth, etc. Perform a benchmarking comparison of financial performance. Note that Chapter 3 of the Koller text analyzes Target and Wal-Mart’s financial metrics. You may choose to review this instead of selecting your own. You may also wish to analyze Home Depot and Lowes since the text uses this example in Chapter 7.
- Identify real examples of competitive advantages for the companies you have selected and whether you expect them to sustain high ROE and ROIC over a long period of time. What business characteristics justify either a high or low valuation?
- In the video about the core-of-value principle, he mentions that a typical large company in the U.S. and Europe is valued at 15-16x Price/Earnings. Observe each company’s valuation multiples such as P/E. Provide your observations and build a case as to why you believe the market has valued your two companies correctly or incorrectly.
- Major types of growth are discussed in Chapter 5. If you were part of the management team of one of the companies that you selected which major type of growth would you pursue and why?

Jan 27-Feb 5 for Class Discussion (no deliverable required)
Costco A and B

Analyzing Performance - Costco A: This case provides a financial statement and ratio analysis for a high-growth retail company. An individual shareholder in the Costco Wholesale Corp. is trying to evaluate the operational performance of the business she has invested in over the last five years. She seeks to answer two questions:

- Has Costco become more or less efficient over this time period?
- How has it financed its growth?

She organizes her analysis into three parts: common-size financial statements, sustainable growth modeling, and benchmarking ratios particular to retail companies.

The case provides information on developments in mass merchandising in the United States, with an emphasis on discounter retailing over the last 40 years. Costco's performance set in historical context provides the relative background information necessary to make a comparative evaluation between Costco and other industry participants.

Forecasting Performance - Costco B: An investor is called on to make a forecast and valuation for Costco. This case provides information about the history of Costco as an investment, industry growth drivers, and forecasting models.

**Feb 10 Group Case Deliverable - Cost of Capital/WACC
Midland Energy Resources, Inc.: Cost of Capital**

The senior vice president of project finance for a global oil and gas company must determine the weighted average cost of capital for the company as a whole and each of its divisions as part of the annual capital budgeting process.

Discussion Question:

- Compute the corporate WACC and the divisional WACCs. - You should consider the use of comparable companies to estimate asset betas for each operating division, and employs the Capital Asset Pricing Model to determine the cost of equity. The analysis involves un-levering and re-levering betas, choosing an appropriate risk-free rate, and computing costs of debt and equity.

Feb 17 Group Case Deliverable - Lululemon Athletica: Pitching an IPO

The managing director at a major investment bank is preparing his team for a visit to Lululemon Athletica, a yoga-inspired athletic apparel company. The investment bank has been following Lululemon's development over the past few years and is impressed by the company's unique positioning and rapid growth. The bank believes that there is a window of opportunity for Lululemon's founder and private equity investors to either undertake an initial public offering or raise debt to fund Lululemon's U.S. expansion.

Discussion Questions:

- If Lululemon were to use \$50 million worth of new common stock, what should be the suggested price range for the IPO? Perform a valuation of Lululemon utilizing the discounted free cash flow method, and other value metrics such as the market approach/comps method (price-to-earnings and market-to-book ratios).
- Assuming the proceeds to the company are \$50 million in each case, should Federal recommend a debt issue or an IPO? Disregard issuance costs.
- What are the key opportunities and risks that should be highlighted for investors in the proposed IPO?

**Mar 10 Group Case Deliverable - Spyder Active Sports
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.

Note: Please see spreadsheet supplement on Blackboard. I have added a few tabs such as descriptions of the M&A transaction comps and also historical financial data for the publicly traded comps.

Discussion Questions:

- 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.

- Perform a valuation of Spyder utilizing the discounted free cash flow method and other value metrics such as the market approach/comps method. Similar to Lululemon, Spyder is not publicly-traded on a stock exchange, but we can still apply the market approach to estimate the company's implied value. Evaluate the financial data provided for Spyder and also the comparable publicly-traded company price multiples and comparable past merger and acquisition price multiples.
- 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?

Mar 24 Group Case Deliverable – H. J. Heinz M&A

During December 2012, Jorge Paulo Lemann, a co-founder and partner at 3G, proposed to Warren Buffett that 3G and Berkshire Hathaway acquire H. J. Heinz Company. Lemann and Buffett, who had known each other for years, jointly decided that the Heinz turnaround had been successful and that there was significant potential for continued global growth. 3G informed Heinz CEO William Johnson that it and Berkshire Hathaway were interested in jointly acquiring his company. Johnson then presented the investors' offer of \$70.00 per share of outstanding common stock to the Heinz board. After much discussion, the Heinz board and its advisors informed 3G that without better financial terms they would not continue to discuss the possibility of an acquisition. Two days later, 3G and Berkshire Hathaway returned with a revised proposal of \$72.50 per share, for a total transaction value of \$28 billion (including Heinz's outstanding debt). Following a forty-day "go-shop" period, Heinz, 3G, and Berkshire Hathaway agreed to sign the deal. But was this, in fact, a fair deal? And what might be the future consequences for shareholders, management, employees, and citizens of Pittsburgh, the location of the company's headquarters?

Discussion Questions:

- Complete a valuation of Heniz for this acquisition based on the financial information provided.
- Why did this transaction propose zero synergies? Discuss and quantify potential synergies that could be realized, including where they come from and the period of time over which they can be realized. Quantify the impact of synergies on Enterprise Valuation.
- Complete a separate valuation based on the Heinz alternative financial assumptions found in the Heinz Exhibits Spreadsheet, under the HNZ Alt tab.

Supplement Information:

<http://www.sec.gov/Archives/edgar/data/46640/000119312513089866/d491866dprem14a.htm>
https://www.bcgperspectives.com/content/articles/mergers_acquisitions_postmerger_integration_dive_conquer_deals_split_synergies/