FBE 529

Financial Analysis and Valuation

Course Objectives: The purpose of this course is to develop students’ financial analysis and valuation skills through extensive hands-on analysis of Harvard cases and additional examples, e.g., the phenomenal growth of Starbucks Corporation and the recent initial public offering of its primary competitor, Peet’s Coffee & Tea, Inc., the financial difficulties and eventual bankruptcy of L.A. Gear, potential liquidity problems at Amazon.com, and general valuation issues for Internet firms. The course covers various approaches for performance evaluation and equity valuation. It stresses applied issues such as the relative advantages/disadvantages of cash flow- and earnings-based measures of corporate performance, the relation between expected growth and firm value, assessing leverage in the presence of off-balance sheet financing, and assessing the reasonableness of discounted cash flow and comparables-based valuations. The major emphasis is on utilizing and interpreting financial data to improve decisionmaking. The applications we cover in the course include equity valuation in mergers and acquisitions, corporate restructurings, bankruptcy, and initial public offerings of common stock, and the use of financial analysis to predict and analyze financial distress, dividend policy shifts, and future financing requirements for growing firms.

Course Materials:

1. Coursepacket (cases and readings), available at the University Bookstore.

2. Supplemental readings (various) to be handed out in class.

3. The Wall Street Journal. You should read the WSJ every day to reinforce the applicability of the issues we study to the business world. Student subscriptions to the WSJ may be obtained at [http://subscribe.wsj.com/semester](http://subscribe.wsj.com/semester). For the zip code, type in 900. For school, highlight U STHRN CAL LS ANG. For professor, highlight DEANGELO, LINDA.

Grading:

- Seven written case analyses (to be done in groups) 49%
- Financial analysis problem set (individual) 5%
- Term project (individual or group) 35%
- Class participation (individual) 11%
**General Course Conduct:**

While this course uses both lectures and cases, its case component is substantial. As you may already know, cases provide a somewhat unstructured and open-ended experience, and one that is characterized by relatively great uncertainty about what the instructor “wants,” what the “right” answer might be, even how to approach the case.

Cases provide an environment in which students learn by grappling with difficult and apparently unique circumstances. This process is inherently uncomfortable, and more so for some individuals than others. As a result, it is tempting to look to the instructor for “cookbook” approaches that reduce the uncertainty inherent in cases. It is inappropriate, however, for the instructor to give extensive guidance on how to proceed, as that would destroy students’ learning experiences. Therefore I will not discuss individual cases with students prior to the class meeting in which the case is discussed. I do provide some structure for each case analysis (see below). Beyond that, it is up to you to identify the salient issues and analyze them. Moreover, you should not look for the “right” answer to a case. Usually, I will present my ideas about how a given case should be approached; alternative approaches, based on somewhat different assumptions, may be equally valid.

Students sometimes ask for copies of my case notes after we have discussed a given case in class. My policy (and that of all other USC instructors who teach cases) is not to distribute these notes. The best cases are deliberately written to be ambiguous. While there are no right answers, there are good arguments and bad arguments. This course is designed to help you learn to distinguish between sensible and not-so-sensible arguments. Handing out my analyses would reduce the ambiguity in the cases and therefore partially defeat the purpose of doing cases. Moreover, distribution of case notes effectively renders that case unusable in the future, since it reduces the incentives for future students to expend time and effort in case preparation. In sum, ambiguity in dealing with case problems is an essential part of the learning experience in this class. Consequently, if you are uncomfortable with this level of ambiguity, you should not take this class.

**Two-Page Written Case Analyses:**

During the term, 7 Harvard cases will be discussed in class. The class schedule below enumerates the class meetings in which each of the 7 cases will be discussed. A brief description, specific assignment, and suggested questions for the 7 cases follow the class schedule. We will form groups for casework at the third or fourth class meeting, and these groups are required to prepare a two-page (text) case analysis for each of the 7 cases.
Written case analyses should contain a discussion of the issues, financial analysis and recommendations. They should be directed to the designated audience. Text is limited to at most two double-spaced pages of 12-pitch font or larger (the font used here) with at most four easily-readable 8 1/2 x 11" pages of exhibits, graphs, and/or figures. You must use a memo format, i.e., no cover page is permitted. The final page of this syllabus illustrates acceptable font size and formatting.

Each written case analysis will be graded on a 1-7 point basis, and is worth 7% of the course grade (total, 49%). Each violation of the rules, e.g., each page over the limit, the use of a cover page, less than double spacing, font size smaller than permitted, will cost your group one point (limited liability does not apply!).

Written case analyses are due at the beginning of the class scheduled for the case discussion (you should also retain a copy for yourself for the class discussion). No late case analyses will be accepted, nor will E-mailed or faxed cases. Finally, written case analyses will be graded for presentation as well as content.

Financial Analysis Problem Set:

The financial analysis problem set in your coursepacket is due at the beginning of class on Tuesday, October 16. This problem set is to be an individual effort, and will be graded on a pass/fail basis (pass = 5% of your grade, fail = 0). The purpose of the problem set is to help you consolidate your understanding of the financial analysis portion of the course before we go on to the valuation portion.

Term Project:

A term project is due at the beginning of class on Tuesday, December 4 (the second-to-last class meeting). We will discuss these projects on the last day of class. You should retain a copy of your project for this discussion and for your records, as term projects will not be returned. The term project may be prepared by an individual or by a group of up to four students. These groups need not be the same groups as for the casework. The term project assignment is to provide a financial analysis and valuation of Peet’s Coffee & Tea, Inc. The report is limited to 25 pages total, including all figures, graphs, tables, references, etc. (but not including a title page). The font and margin requirements are the same as for the written case assignments, as are all the other rules, e.g., the assignment is due at the beginning of class, and no late projects will be accepted.
The term project must incorporate the following topics covered in this course: performance evaluation via cash flow and ratio analysis, quality of earnings analysis, economic and market value added; equity valuation, both via some variant of discounted cash flow and via comparables analysis, including a recommendation on whether Peet’s equity is fairly-, over- or under-valued at the current market price. Your analysis should adjust for Peet’s off-balance sheet financing (if material). Term projects will be graded for presentation as well as content, and will count for 35% of the course grade. Discussion of your projects on the last day of class will count for class participation, and you should be prepared (as with all case discussions) for cold-calling.

**Class Participation:**

The final 11% of the course grade will be awarded for class participation. This grade will reflect my assessment of both the quantity and quality of an individual’s contribution to the classroom learning environment and the analysis of cases, the Peet’s term project, and other issues discussed in class. To facilitate grading for class participation you should choose a seat for the entire term early in the semester, when I will pass around a seating chart. You should also use your name cards for the first six weeks of the course. You should be prepared for cold-calling in all class meetings, especially in those devoted to discussion of the seven cases and of the term project.

In addition, as we will cover 7 cases and there are 50 students per class, I will assign 7 students to each case alphabetically, and these 7 students will be primarily responsible for the class discussion of their respective cases. While I will lead each of these discussions myself, I expect the 7 students who have case responsibility to be prepared to answer any questions about the case, and generally to contribute actively to the discussion.

Regular attendance and class participation are necessary, but not sufficient for a student to receive one of the higher letter grades in this class. You should realize that the points awarded for class participation are sufficient to cost you a letter grade or more should you choose not to participate fully and regularly.
## Class Schedule

<table>
<thead>
<tr>
<th>Date</th>
<th>Topic and Readings</th>
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<tbody>
<tr>
<td>Tues, Aug 28</td>
<td>Introduction and Course Overview</td>
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<tr>
<td>Thurs, Aug 30</td>
<td>Basic Framework and Techniques of Financial Analysis</td>
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<td>Tues, Sept 4</td>
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<td>Thurs, Sept 6</td>
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<td></td>
<td>“Statements of Cash Flows: Three Examples,” Harvard Business School #9-193-103. You should prepare answers to the questions at the end of this reading for the fifth class meeting.</td>
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<td></td>
<td>Starbucks Corporation 2000 annual report.</td>
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<tr>
<td></td>
<td>Peet’s Coffee &amp; Tea, Inc. 2000 annual report.</td>
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<tr>
<td>Tues, Sept 18</td>
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<tr>
<td>Thurs, Sept 20</td>
<td><strong>Reading:</strong> To be handed out in class.</td>
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Thurs, Sept 27 Corporate Performance Evaluation: Assessing Earnings Quality

**Reading:** Fox, Justin, “Learn to Play the Earnings Game,” *Fortune*, March 31, 1997, pp. 76-80.


Thurs, Oct 4 Assessing Leverage with Off-Balance Sheet Financing


Tues, Oct 9 Corporate Performance Evaluation: Economic and Market Value Added

Thurs, Oct 11


Tues Oct 16 Corporate Performance Evaluation: Wrap-up

**Financial Analysis Problem Set** is due at the beginning of class.

Thurs, Oct 18 Equity Valuation Using Discounted Cash Flow Analysis (WACC Approach)

Tues, Oct 23

**Reading:** “Note on Alternative Methods for Estimating Terminal Value,” Harvard Business School #9-298-166.

“Leveraged Betas and the Cost of Equity,” Harvard Business School #9-288-036. **Warning:** This reading uses different formulas from
those we will employ in this class. Therefore, you should read it for content, and not attempt to memorize specific formulas.

Thurs, Oct 25  **Case #4: Pinkerton (A),** Harvard Business School #9-291-051

Tues, Oct 30  Assessing the Reasonableness of a Discounted Cash Flow Valuation


Thurs, Nov 1  DCF Valuation Using the Adjusted Present Value Technique

**Reading:** “Note on Adjusted Present Value,” Harvard Business School #9-293-092.

Tues, Nov 6  Comparables-Based Valuation Methods #1


Thurs, Nov 8  **Case #5: Tiffany & Co.,** Harvard Business School #9-288-022.

Tues, Nov 13  Comparables-Based Valuation Methods #2


Thurs, Nov 15 Valuation of Internet Firms

Reading: Tully, Shawn, “Has the Market Gone Mad?” *Fortune*, January 24, 2000, pp. 80-86.


Tues, Nov 20 **Case #6: Internet Securities, Inc.**, Harvard Business School #9-899-149.

Thurs, Nov 22 THANKSGIVING

Tues, Nov 27 Financial Distress, Insolvency, and Bankruptcy #1


Tues, Dec 4 Financial Distress, Insolvency, and Bankruptcy #2

**Peet’s Term Project** is due at the beginning of class.


L.A. Gear 1996 annual report.

Thurs, Dec 6   Peet’s Coffee & Tea: Discussion of Term Projects
Case #1: The Home Depot, Inc.

Case Writeup Assignment:

Your company, Financial Consulting Group, Inc., has been hired by the management of The Home Depot, Inc. as an independent consultant to evaluate the firm’s growth strategy, financial performance, and future external financing requirements. Your boss, Ashley Ellison, has asked you to provide her with a report that, subject to her review, will be presented to the Board of Directors of Home Depot. Management’s intent in hiring your firm was to obtain independent advice at a crucial juncture in the firm’s history, when it has just reported its first earnings decline as a publicly-traded company. Management is concerned that the firm not lose its growth momentum, but rather that the factors underlying the earnings decline be identified and corrected as soon as possible.

Discussion Questions:

1. Evaluate The Home Depot’s growth strategy.

2. How well has the company implemented its strategy?

3. Analyze Home Depot’s financial performance and cash flow during the fiscal year 1985. How well did the company perform in 1985, measured relative to its performance in prior years?

4. How does Home Depot’s performance compare to that of Hechinger? (You may use the analysis in case exhibit 3 as a guide to your analysis.)

5. What factors caused Home Depot’s earnings decline in 1985?

6. Recommend a plan of action to Home Depot’s directors based on your analysis of the company’s current performance and future growth plans. Your recommendation should include a thorough analysis of the company’s operating performance, growth strategy, and external financing requirements.
Case #2: The Murray Ohio Manufacturing Co.

Case Writeup Assignment:

Write a report from David McIntosh to Dianne Simmons that recommends whether or not the Commonwealth Investment Group should continue to hold the common stock of the Murray Ohio Manufacturing Company in its equity income fund. This fund is marketed to dividend-oriented investors, and Murray Ohio has followed a consistent policy of increasing cash dividends (from $0.67 in 1975 to $1.20 in 1984).

Discussion Questions:

1. Analyze Murray Ohio’s recent financial performance, especially the “quality” (composition) of its earnings and cash flows. Can the company afford to maintain or increase its current dividend if operating conditions remain about the same?

2. Evaluate management’s business strategy for the future. What does this strategy imply for the company’s future cash requirements? Given this new strategy, is the company more or less likely to maintain or increase its current dividend?

3. What other potential sources of value (other than cash dividends) to the Commonwealth Investment Group do you see from holding the common stock of Murray Ohio? Are there alternative managerial strategies that might make more sense than the one currently on the table?

4. What are the implications of your analysis for the current holders of Murray Ohio’s common stock? What should the Commonwealth Investment Group do? What strategies are available, and which of these strategies do you recommend?
Case #3: Harnischfeger Corporation

Case Writeup Assignment:

Write a research report from Peter Roberts to the President of the Exeter Group that makes a recommendation on the investment potential of Harnischfeger’s common stock. Your report should include an examination of the firm’s earnings, cash flows, operating results, and corporate strategy.

Discussion Questions:

1. Identify all the accounting policy changes and accounting estimates that Harnischfeger made during 1984. Estimate, as accurately as possible, the effect of these items on the company’s 1984 reported profits.

2. Identify which of these accounting changes and estimates are “cosmetic” -- that is, have no cash flow effect -- and which have an effect on cash flow.

3. What do you think are the motives of Harnischfeger’s management in making “cosmetic” changes in its financial reporting policies? How does your assessment of management’s motives impact your view of the desirability of investing in Harnischfeger’s common stock?

4. Assess the company’s performance, given the insights you have gleaned from answering questions #1, 2, and 3 and the information in the case on the company’s turnaround strategy. What difficulties do you encounter, given management’s changes in the firm’s financial reporting strategy?

5. Should the Exeter Group invest in Harnischfeger’s common stock at this time, given the firm’s progress to date in executing management’s turnaround strategy?
Case #4: Pinkerton (A)

Case Writeup Assignment:

Write a memo from CPP’s valuation task force to the CPP board, proposing a $100 million bid for the net assets of Pinkerton, and ignoring the proposed strategies for financing the acquisition. [Carry out a DCF analysis using the WACC approach. You should use five years as the relevant forecast horizon, and estimate terminal value using your estimate of WACC and the 5% growth rate given in the case. The formula for the present value of a growing free cash flow perpetuity appears on p. 2 of the Harvard reading on estimating terminal values. Additionally, assume that depreciation expense = zero and that all income taxes are paid currently in cash.]

Discussion Questions:

1. Based on your DCF analysis, how much should Tom Wathen be willing to pay for the net assets of Pinkerton? Did the $85 million bid two weeks earlier make sense, given your analysis? Specifically, how will Wathen create value from this acquisition? Develop and value the free cash flows from Pinkerton and also from the CPP margin improvements.

2. What additional assumptions, if any, are necessary for Wathen to justify a $100 million bid to the CPP board? Are these assumptions reasonable, given the two firms’ historical performance?

3. What issues are involved in the bidding strategy for buying Pinkerton from American Brands? How much less than $100 million can Wathen offer, and still have a reasonable chance of prevailing in the bidding?

4. If Wathen proceeds with a $100 million bid for Pinkerton, which financing alternative should he choose? Why? Are you comfortable with the ability of the combined firm to service debt requirements under each of these financing alternatives? You should not prepare a quantitative answer to these questions, but you should spend some time thinking qualitatively about how to structure an approach to answer them.
Case #5: Tiffany & Company

Case Writeup Assignment:

You are a financial analyst working directly for Mr. Thomas Andruskevich, senior vice president for finance at Tiffany & Company. Mr. Andruskevich is concerned about the pricing of Tiffany’s upcoming IPO. Earlier, he asked you to perform a comprehensive DCF analysis as a check on the pricing recommendations of the firm’s investment bankers. Your analysis, which you delivered to him one week ago, supports the price range of $21 to $23 per share that was indicated in the preliminary documents filed with the SEC. It also suggests that, under more aggressive growth rate assumptions, a price of at least $25 per share is warranted. Mr. Andruskevich confronted the investment bankers with this information. Their reaction was that DCF analysis, while somewhat useful, is by itself unreliable for IPOs and, based on their analysis of the “comparables” in case exhibits 3-6 and current stock market conditions, a price of $22-$23 per share is more realistic. Mr. Andruskevich has asked you to perform an analysis of the data in case exhibits 3-6 before tomorrow’s pricing meeting. Write a memo to him that indicates whether or not Tiffany should agree to the $22-$23 per share price suggested by the underwriters and, if not, what evidence Mr. Andruskevich should cite that supports a higher price.

Discussion Questions:

1. Why do you think the underwriters will not rely on DCF analysis to price the Tiffany & Company IPO?

2. Review Tiffany’s operations since the LBO. Do you see difficulties here that might affect the offer price?

3. What characteristics of Tiffany’s business make the firm’s equity especially difficult to value?

4. Use the comparable firm data in case exhibits 3-6 to value Tiffany’s equity. What problems do you encounter? If you were to put together your own sample of comparable firms, what would you do differently? If your analysis supports a price in excess of $22-$23, what evidence should Mr. Andruskevich cite to convince the underwriters?
Case Writeup Assignment:

You are an independent business consultant, recently going into business for yourself after working for several years at a major venture capital firm. Gary Mueller, CEO of Internet Securities, Inc. (ISI) is a good friend of yours from Harvard Business School days. He has just contacted you to advise him on raising additional equity capital for ISI. Although he has already engaged Donaldson, Lufkin & Jenrette, he feels your friendship and your specialized expertise will provide a valuable check on their analysis. You have agreed, and your first task is to provide him with a preliminary (and independent) estimate of ISI’s total enterprise value using data for the comparable firms from case exhibit 16. [Gary does not think that a discounted cash flow approach is sensible to value ISI at this juncture.] Gary is also interested in your assessment of the relative attractiveness of raising capital from the public via an IPO, from a financial buyer, or from a larger firm in the financial information services industry.

Discussion Questions:

1. Why do you think Gary Mueller is so pessimistic about the usefulness of the DCF approach?

2. What is your estimate of ISI’s total enterprise value in October 1998? What qualitative factors make the company worth this much, in your opinion?

3. Is the $12.5 million investment amount discussed in the case sufficient to fund ISI’s operations until the firm can begin generating positive operating cash flow? Why or why not?

4. From whom should Gary Mueller raise additional equity capital? Should he approach a major investment bank such as DLJ about underwriting an IPO at this time? Or should he seek a financial buyer or arrange for ISI to be acquired by a larger, more well established firm in the financial information services industry? Does the identity of the buyer affect the amount of your valuation?

5. What advice would you give Gary on how to structure a deal with a financial buyer? What advice would you give him on how to structure a deal with a larger firm in the financial information services industry?
Case #7: National Convenience Stores

Case Writeup Assignment:

You are an independent financial consultant working for the law firm that represents the equityholders of National Convenience Stores (NCS). Prepare a valuation of NCS. You should use an APV approach on the cash flow projections provided in case exhibit 4, assume that debt capacity is 4.0 times projected 1993 EBITDA, or 4.0 times $34.5 million = $138 million, and that, upon emerging from bankruptcy, the firm will issue new perpetual debt of $138 million that pays 11% interest. You should also assume that creditors’ claims will be satisfied based on the rule of absolute priority. Once you have prepared your initial valuation, you may, if you wish, alter some of the assumptions underlying the cash flow projections in case exhibit 4. In any case, your case writeup should be a memo to the law firm, recommending how they might negotiate the highest-valued outcome for their clients, given your valuation and the other facts in the case.

Discussion Questions:

1. What claimant classes does NCS have, and how much (nominally) is each of those classes owed?

2. How will the NCS equityholders fare under your valuation based on case exhibit 4?

3. What avenues might you pursue to enable the law firm to negotiate a better outcome for the equityholders?

4. Can you make the case for a higher valuation? How much higher?

5. How much more value will the equityholders receive if the law firm can gain acceptance of this second valuation?

6. What ethical problems, if any, do you see with the valuation approach you have taken in this case?
The purpose of this page is to illustrate acceptable font, spacing, and margin usage for written work for FBE 529. Font size must be at least 12, the size illustrated here. Double spacing is required. Acceptable side, top, and bottom margins are shown here. Memo format is required, using single spacing for the information in the header. Each violation of the rules, including more than two pages of text and more than four pages of exhibits, will be penalized by the deduction of one point.

Exhibit fonts can be smaller, but must be easily readable (in my judgment). Violations here will also be penalized by the deduction of one point.