

**HONG KONG UNIVERSITY OF SCIENCE & TECHNOLOGY**  
School of Business and Management

**FINA 535 – Strategic Finance and Value Creation**

Fall 2002

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**Course outline**

The course focuses on valuation and value creation. Through a combination of lectures and case studies, participants learn valuation techniques and examine how valuation analysis can be applied to enhance financial and strategic decision-making. The course's final sessions examine how firms create (and sometimes destroy) value in corporate restructuring transactions – including mergers and acquisitions, spinoffs, equity carve-outs, and leveraged buyouts. The focus here is on understanding how corporate restructuring transactions work, the theory concerning how they affect value, and the empirical evidence on how much shareholder value gets created in these transactions.

**Prerequisites**

The prerequisite for this course is FINA 512: Corporate Finance. In lectures and case discussions, I will assume you have a working knowledge of financial accounting, cash flow estimation, Capital Asset Pricing Model (CAPM), capital budgeting, and capital structure. It is, therefore, your responsibility to be thoroughly familiar with these topics. A review of Chapters 5, 6, 7, 8, 9, 17, and 18 of Brealey and Myers (7<sup>th</sup> edition) or an equivalent textbook would be helpful.

**Readings**

*Required Text*

1. *Valuation: Measuring and Managing the Value of Companies* 3<sup>rd</sup> edition, 2000, by Tom Copeland, Tim Koller and Jack Murrin.
2. Case studies, outside readings, and lecture notes.

*Supplementary Readings*

1. *Financial Modelling*, 2<sup>nd</sup> edition, by Simon Benninga (The MIT press 2000).
2. *Corporate Finance: A Valuation Approach*, by Simon Benninga and Oded Sarig (McGraw Hill 1997).
3. *Business Analysis & Valuation: Using Financial Statements*, by Palepu, Bernard, & Healy (South-Western 1996).

4. *The New Corporate Finance: Where Theory Meets Practice*, by Donald Chew (McGraw Hill 1993).
5. *The Quest for Value* by G. Bennett Stewart's (Harper Business 1991). Stewart's book has a good discussion of Economic Value Added and many interesting anecdotes illustrating value creation and destruction at U.S. corporations.
6. *The Asian Wall Street Journal*. Other recommended business periodicals are *The South China Morning Post* (the business section), *The Economist*, *Forbes*, *Business Week*, and *Fortune*.

## Office Hours

Office hours are by appointment.

## Grading

Your grade in this course will be based on your performance on the problem sets, case write-ups, class participation, a mid-term exam and a final (take-home).

There are two problem sets. Working on these problems will help you in understanding the material of this course without “grade pressure”. The solutions are due on the dates indicated below and late submissions are not accepted. If I can see you are making a good-faith effort to work the problems, you will receive full credit. Each homework solution turned in counts five-percentage point for a total of 25 percentage points towards your final grade. Your submissions will not be returned to you so please keep extra copies for your reference.

There are two case assignments in this course and each case write-up contributes 20 percent towards your final grade.

Problem Sets	10%
Case Analyses	30%
Mid-term Exam	15%
Class Participation	10%
Final Exam	35%

## Case write-ups

Case write-ups are to be turned in at the beginning of class on due dates. Late submissions are not graded. Cases can be done in groups of 5 students. If you work in groups, hand in one copy of the write-up with names of all group members. At the end of the course, you will evaluate each of your group members on the contribution they made to the group assignments. A sample peer-review form is enclosed. Your group members' assessment of your contribution will enter into your class participation grade.

**Format and length of case write-ups:** Case write-ups need not be long (3-4 pages would be sufficient to answer the suggested questions for each case. Tables and figures can be appended to the end). The order in which you answer the case questions is not important. Your logical order may be different from the sequence in which these questions appear on the syllabus. The exhibits

and tables should be numbered and referenced in the text when needed to support your arguments. When you are referring to a table, you should explicitly indicate why you want me to look at that table, what numbers you consider important, and what conclusion you draw from them. Tables and exhibits that are not referenced in the text of your report should not be included.

### **Auditing, class participation, attendance, seating**

*Auditing:* Students may not audit this course. If you want to take this course, you would have to be registered in the course with the expectation of receiving a letter grade. Once registered, you cannot convert this into an audited course or expect to get an incomplete. Your only options are to drop the course during add/drop period or withdraw if permissible under ‘Regulations Governing Postgraduate Studies’.

*Class participation and attendance:* Class participation grade is determined by your participation in the class discussion. An important pre-condition to getting points on class participation is that you come to class. You cannot participate if you are frequently absent. Frequent absences would negatively affect your participation grade. The class starts at the scheduled time, precisely. Make sure that you are in your assigned seat a few minutes before the session starts. Consistent tardiness will also have a strong negative influence on your class participation grades.

*Seating:* To ensure that your class participation grades are accurately recorded, this course has fixed seat assignments. By the second week of classes, you pick a seat where you would like to sit for the rest of the term. Once chosen, the position is fixed and no changes are allowed later. There would be name cards in front of your seat at the beginning of each class session. Please do not take the cards away; it is my responsibility to remove them from the holders at the end of each session.

### **Academic Integrity**

It is expected that you will support and maintain a high standard of academic integrity. Cheating on exams and other academic misconduct will result in a failing grade and additional sanctions. A gross violation of Academic Regulations would be using solutions to the cases and home-works from previous years, be it someone’s class notes or case solutions, whether verbal or written (see section 12.1 Academic Dishonesty, of the Academic Calendar 2000-01). Please ensure that telephones and pagers are switched off during class period.

### **Course Outline**

1. September 7, 2002      Managing value - the governing objective  
   Valuation: An overview of processes and principles  
   Discounted Cash Flow valuation

*Readings:*

1. *Case:* Walt Disney Productions, June 1984,  
Darden UVA-F-0676 (No write-up required).
  2. Copeland, Koller and Murrin, Chapters 1, 5, 8, 9  
and 10.
2. September 14, 2002      Valuation tools and their applications  
   Valuation of dot.com companies  
**Problem Set 1 Due**            Relative valuation (valuation by multiples)

*Readings:*

1. Timothy A. Luehrman, What's it worth? A general manager's guide to valuation, *Harvard Business Review*, May-June 1997.
  2. Copeland, Koller and Murrin, Chapters 11, 12, 13, and 15
  3. Kaplan, Steven N., and Richard S. Ruback, 1996, "The Market Pricing of Cash Flow Forecasts: Discounted Cash Flow vs. the Method of Comparables, *Journal of Applied Corporate Finance* 8(4), 45-60.
3. September 21, 2002  
**Problem Set 2 Due**
- Fundamental drivers of a company's value  
Cash flows drivers – Return on Invested Capital (ROIC) and Growth  
Value Metrics: EVA™, MVA, CFROI etc.  
Value Based Management

*Readings:*

1. Copeland, Koller and Murrin, Chapters 1 through 6.
  2. Valuing companies: A star to sail by? *The Economist*, August 2, 1997
  3. Shawn Tully, The Real Key to Creating Wealth, *Fortune*, September 20, 1993.
4. September 28, 2002  
**Case Due**  
**Mid-term Exam**
- Mid-term exam**  
*Case:* Interco, Harvard Business School, 9-291-033
5. October 5, 2002  
Value creation in mergers & acquisitions

*Readings:*

1. Lehn, Kenneth and Mark Mitchell, "Do bad bidders make good targets?" *Journal of Applied Corporate Finance* (Summer 1990).
6. October 12, 2002  
**Case Due**
- Value creation in restructuring transactions  
Spinoffs and Equity Carveouts

*Readings:*

1. *Case:* Time Inc.'s entry into the entertainment industry (A) *Harvard Business School*, 9-292-117.
2. Patrick Cusatis, James A. Miles, and J. Randall Woolridge, "Some New Evidence that Spinoffs Create Value," *Journal of Applied Corporate Finance*, Summer 1994.

3. David M. Glassman, "Spinoffs and Spinouts: Using Securitization to Beat the Bureaucracy," *Journal of Applied Corporate Finance*.
  4. Katherine Schipper and Abbie Smith, "Equity Carve-Outs," *Midland Corporate Finance Journal* 4(1) 22-32, Spring 1986.
7. October 19, 2002      Creating value by restructuring liabilities
- Leveraged buyout transactions
- O.M. Scott & Sons Leveraged Buyout  
*[No write-up required]*
- Readings:*
1. Michael Jensen, "Eclipse of the Public Corporation," *Harvard Business Review*, September-October 1989.
  2. *Case: O. M. Scott & Sons Leveraged Buyout*, Harvard Business School, 9-190-148.
8. October 26, 2002      Final examination

## Case problems

### Case 1: Walt Disney Productions, June 1984

1. What is Disney's relative competitive position in each of its major business segments? How well has Disney performed in its segments and in the aggregate? What criteria should you use to judge performance?
2. What is Disney's apparent business strategy?
3. Is Disney a "growth" company? What should define a growth company?
4. Why was this excellent company a target of a takeover attempt?
5. Should Disney repurchase Saul Steinberg's shares? If so, what should the repurchase price be? How will the price of Disney's shares respond to the purchase announcement? Does the repurchase represent a transfer of wealth? If not, and if Steinberg completes his takeover, what are the wealth consequences for Steinberg? For the former public shareholders?

### Case 2: Interco

1. Assess Interco's financial performance. Why is the company a target of a hostile takeover attempt?
2. Should the board be persuaded by the premiums paid analysis (Exhibit 10) and the comparable transactions analysis (Exhibit 11)? Explain.

3. Wasserstein, Perella, & Co. established a valuation range of \$68-\$80 per common share for Interco. Show that the valuation range can follow from the assumptions described in the discounted cash flow analysis section of Exhibit 12. Which assumptions would you have questioned? Why?

### **Case 3: Time Inc.**

Richard Munro, Time Inc.'s chairman and CEO must respond to a hostile tender offer from Paramount Communications. Paramount conditioned its bid on cancellation of Time's plans to merge with Warner Communications. Several months before the hostile Paramount bid, Time had announced its plans to merge with Warner after careful consideration of a comprehensive list of possible partners, including Paramount. The Board endorsed Munro's decision to merge with Warner because the two firms held a wide range of complementary assets. If Time continued with its plans to merge with Warner, Time's shareholders would forgo at least \$175 per share in cash and possibly more. On the other hand, a merger with Paramount was not part of Time's long-term strategy. Munro must recommend a specific course of action to the Board at its emergency session.

1. Evaluate Time Inc.'s global strategy for the 1990s? Time's valuation of Warner suggests that Time was expecting its combination with Warner to generate some synergies. What are the sources of such synergies?
2. Estimate Warner's value using Discounted Cash flow. Do you agree with the valuations of Time and Warner done by investment bankers?
3. On June 7, 1989, Time received an offer from Paramount. Richard Monroe, the CEO of Time, has the following options. Evaluate these options.
  - (a) Accept Paramount bid or negotiate with Paramount (and at the same time put anti-takeover defensive measures to strengthen Time's bargaining position).
  - (b) Reject Paramount bid and go ahead with the Warner merger using all stock-offer
  - (c) Change the terms of Warner merger to some combination of cash and stock or perhaps all cash

### **Case 4: O. M. Scott & Sons Leveraged Buyout**

1. How did the leveraged buyout change the way Scott was managed?
2. What are the important characteristics of the "rules of the game" at Scott after the buyout?
3. What did Clayton & Dubilier contribute to the Scott organization?
4. Did being highly leveraged hurt Scott's competitive position?
5. What do you think Clayton & Dubilier's plans are for Scott?

## Peer Review Form for Group Assignments

NAME OF GROUP MEMBER BEING EVALUATED:

1	2	3	4	5	Works well with group and treats all group members as colleagues
1	2	3	4	5	Completes individual task requirements to achieve group goals
1	2	3	4	5	Attends all group meetings or provides advance notice when absent
1	2	3	4	5	Is open to feedback, listens to and considers others' point of view
1	2	3	4	5	Offers ideas and alternative approaches on how to achieve group goals. Encourages innovative thinking
1	2	3	4	5	Works to enable group to move ahead efficiently; goes beyond the requirements of the tasks; looks for opportunities to improve

1. Would you like to work with this person again?

2. Evaluate this group member overall on a scale of 1 to 10 (10 being the highest):