

**Hong Kong University of Science & Technology
School of Business and Management**

FINA 321 – Advanced Financial Management

Spring 2003

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Office hours: You are welcome to come by my office to discuss questions. If I am busy at that time, we can make an appointment.

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COURSE DESCRIPTION

This course introduces the concepts and techniques of valuation, and how to use these tools to guide managerial decisions. Through case studies, we will learn to apply the concepts and techniques to real-world situations. We will examine how financial statements are used in valuation; how to value cash flows; how to estimate cost of capital; how to estimate the value of a firm, and how to value assets or companies in emerging markets. We will apply the valuation techniques to mergers and acquisitions and discuss the causes and effects of these transactions. Topics on capital structure theory and corporate governance will also be discussed. Students planning to pursue a career in the corporate finance sector (investment banking, financial analysis, consulting, etc.) should find this course interesting and useful.

PRE-REQUISITES: Finance 111, Finance 221.

COURSE WEB SITE: <https://www.bm.ust.hk/~fina321/index.htm>. Please visit the web site regularly for announcements. Lecture notes, case questions, and assignments will be posted there prior to class discussion. You will need a password (to be provided) to access the web site.

READINGS

The required text is *Principles of Corporate Finance* (BM hereafter) by Brealey and Myers, 7ed., McGraw-Hill, 2003.

There are cases and articles to be discussed during the semester. All of the cases and articles are reserved in the library.

It is expected that you will be an aggressive reader of business publications, including *The Asian Wall Street Journal*, *The South China Morning Post* (the business section), *The Economist*, *Fortune*, *Business Week*, *Far Eastern Economic Review*, and so forth. Please look for opportunities to apply class material to your reading of the business press and volunteer your observations in class.

Topics will be discussed by lectures and case analysis. To derive maximum benefit, it is essential that prior to each class you read the assigned chapters / articles, and read and prepare case assignments.

STUDY GROUP

As an important part of the course requirement, you will form study group to analyze cases and conduct a project. You are responsible for selecting members of your group. Each group should have 5 or 6 members. Please submit your group member list as soon as you can but **no later than February 12**. Students who are not a part of a group of size 5 or 6 on February 12 will be combined in an arbitrary manner into groups.

GRADING

Your course grade will be determined by your performance in a mid-term examination (40%), class participation (10%), a group-based case report (10%), and a group project (40%).

Mid-term examination: The exam will be close-book, close-note, covering all materials discussed. More details will be given later in the semester.

Class participation: Your grade on class participation depends on the quality of your questions and answers in lectures and case discussion. We will keep track of the level of your participation throughout the course.

Project and case report: Your grade on the project and the case report will be adjusted according to a peer evaluation scheme. Suppose out of a maximum of 50, your group obtained 40 points on the project and the case report. These 40 points constitute the basic grade on the project and the case. Suppose your group has 6 (or 5) members. Each member of your group will be asked to score every other member on a scale of 1 to 5 (or 4 in case of a 5-member group), indicating their evaluation of each member's relative contribution to the group's efforts (excluding himself/herself). A score of 5 (or 4 in case of a 5-member group) is the best possible, and 1 is the lowest possible. The average score of each group member will then be computed. Each of the group members will then be ranked from 1 (the best) to 6 (the worst) according to the average score that he/she receives. Suppose the rank for an individual is x , and there are n group members share the same rank x . Then the eventual case and project grade will be determined by the following formula:

$$\text{Case and Project Grade} = (\text{Basic Grade}) + (0.15) * (\text{Basic Grade}) * \max \{ [(3-x)/2]/n, 0 \}$$

Thus, if your rank is 2 ($x=2$), you are the only one who rank 2 in your group ($n=1$), and the basic grade is 40 for your group, then your case and project grade is $(40) + (0.15) * (40) * \max \{ [(3-2)/2]/1, 0 \} = 43$

If two (or more) individuals have the same rank (1 or 2), their bonus points will be equally shared. Following the above example, if another member of your group ranks 2 (i.e., $n=2$), then your case and project grade is 41.5.

The peer evaluation will be confidential, and will be done at the end of the semester. Note that you will NOT be allowed to give the same score to any two people in your group. If you do, or if you do not score someone in your group, those individuals will be assigned a score of 2.5 from you. Also, as a penalty to you, your average score will be lowered by 1.

Here is an example of how the score for the entire course will be computed. Suppose your group of 6 members gets the following points on the case and project reports:

Case: 8/10
Project: 32/40

Your peer evaluation rank: 1 (and no other member rank 1)

Class discussion of case question: 7/10

Mid-term exam: 35/40

Your total score: $(40) + (0.15)(40) * \max \{ [(3-1)/2]/1, 0 \} + 7 + 35 = 88$

COURSE POLICIES

Seating: This course has fixed seat assignments. Once you join a group, you will be sitting with your group members in a designated area of the classroom. The position is fixed and no changes are allowed later. We have prepared name cards for each one of you; these name cards would be placed in front of your seat at the beginning of each class session. Please do not take the cards away; it is our responsibility to remove them at the end of each session. To help us knowing you, we will request you to provide your basic information and provide a small photograph of yourself. More instruction will be given in class.

Deadlines: The project and case report are due on the dates indicated in the Course Schedule. Late submission will not be accepted or subject to grade penalty in case of preliminary project reports (see Group Project for details).

Exam: During the exam you have to rely entirely on your own intellectual endowments. There are serious consequences including failing grade and additional sanctions for engaging in unethical conduct. Do not miss the exam. No make-up exam will be given, unless for emergency reasons (such as sickness) and certification documents (such as doctor's diagnosis) are presented.

CASE ANALYSIS

A case provides factual details and organizational circumstances surrounding a particular managerial situation. The essence of case analysis is to examine the facts by applying the concepts discussed in the class in arriving at your recommendations. A significant portion of case analysis grade depends on the justification of your recommendations. In general, the following guidelines will apply to all case studies:

- We will discuss 7 cases in this class. Your study group is required to submit a written case analysis of **the Boeing 777 case** and be ready to present the case in class.
- The case report should not exceed five double-spaced typed pages. This limit excludes spreadsheets, tables, charts and graphs. It is helpful if you think of your team as a consulting firm and the case company as your client. The suggested questions (to be provided) are to get you started. However, like any consulting assignment, your report should be organized and structured as if you were actually presenting it to your client. Merely answering the questions is not adequate and, therefore, unacceptable.
- The written case (and project) report will be graded based on the following criteria:

Weight	Category
30%	Written presentation, organization, readability, grammar and relevance
30%	Logic and justification underlying your recommendations
40%	Numerical Analysis and scientific evidence
- I will do all the remaining cases. Although you are not required to submit reports for these cases, you should read the cases thoroughly and actively participate in case discussion. There will be assigned questions on these cases. Be prepared to answer questions during class discussion of the cases. Your individual performance in case discussion will affect your participation grade.
- Finally, the following seven steps can be very helpful in dealing with case studies in general:
 1. Read the case through rather quickly for familiarity of facts and other details
 2. Read the case a second time to select salient facts, issues etc.
 3. Study all the exhibits carefully—in Finance cases the real story most often is in numbers
 4. Determine the major and minor issues
 5. Analyze the issues using concepts and techniques discussed in class
 6. Resolve conflicts regarding validity of data and assumptions
 7. Make and justify your recommendations

GROUP PROJECT

The project is a comprehensive analysis of a business group in the greater China area (Hong Kong, Mainland China, or Taiwan). It requires you to respond to the following set of issues.

A. Basic Information

1. *Group history*: Describe the history of the business group.
2. *Business portfolio*: Illustrate the business structure of the group. What are the main businesses of the group, including its affiliated public and private companies? Describe the group's competitive position in its main business segments. Identify major competitors in these business segments. Does the group or its affiliated companies hold a dominant position in each of their respective business categories? What is the contribution of each of the business segments to the overall sales and profits of the group?
3. *Ownership structure*: Illustrate the ownership structure of the business group. Who is the controlling owner? How does the owner achieve effective control of the group's affiliated companies (through direct ownership, stock pyramids or cross shareholdings)? How much ownership and control the controlling owner possesses on each of the affiliated companies?
4. *Management and boards of directors*: Describe the management and the boards of directors of the group's listed affiliated companies. Are top managers or directors family members or outside professionals? How independent are the boards? Do the boards compose of mostly inside directors? Is there any independent director?
5. *Corporate transparency*: Evaluate the group's disclosure practices. How informative are the group's annual reports and financial statements? Do you find any inconsistencies or irregularities in the disclosed reports? Was the group investigated or punished by government agencies for accounting frauds or corporate crimes?

B. Strategies

6. *Strategies for growth*: Describe the group's growth strategy during the past 10 year. Did it invest and growth certain businesses, or divest and downsize certain businesses? Did it engage in vertical integration (disintegration) or diversification (refocusing) strategies?
7. *Financial policies*: Describe the financing strategies of the group and its individual listed companies. Are there similarities or differences among the affiliated companies' financial policies?

C. Issues on family or government ownership

8. *Family succession issues* If the business group is family owned, identify the roles of each family member in the group. Did the family members' positions changed in the past 10 years? Is the founder still control the group? If the founder is old or has died, were there shifts in business or ownership structures, or changes in financing and growth policies around the succession?
9. *Government ownership issues* If the business group is located in Mainland China and is majority controlled by the state, analyze the effects of government ownership on the group's investment and financing policies, and the roles of government ownership on corporate governance.

D. Case study

10. *Case study*: Perform a case study of the group's investment, financing, or corporate governance practices. Select an event (or a series of related events) of investment, financing, or corporate governance. Analyze how the event(s) created or destroyed value for shareholders. You may want to perform an analysis of the market reactions of the event(s), and conduct a valuation using the discounted cash-flow technique.
11. *Recommendations*: Provide your recommendations on the group's future investment, financing, and/or corporate governance policies. Your recommendation should be justified with scientific evidence. It would be informative if you show how much shareholder value can be created if the suggested changes are implemented?

Important notes:

- *Deadlines*: You will be assigned a business group, through a lucky draw. You should begin to collect and analyze data soon. The project has several deadlines. By **March 26**, you will submit the first preliminary report addressing the first 9 issues. All preliminary reports will be returned for revision under the close supervision of myself. By **April 16**, you will submit the second preliminary report that revises the first 9 issues based on my comments and further addresses remaining issues (the 10th and 11th issues). After my comments of your second preliminary report, you will continue to revise the report that addresses all the issues and submit the third report no later than **May 7**.
- *Presentation and final revision*: All of you will present your project on **May 12 or 14**. After your presentation, you have a few days to make a final revision. The final version of the report is due on **May 19**. Your grade of the project will depend on this final version.
- *Project focus*: You have the flexibility to determine the central issue of the project and the weight of each of the 11 issues in the project report. For example, if you focus on corporate governance practices, you may want to perform more analysis on the group's ownership and governance structures. If your focus is the group's financial policies, you may want to provide more analysis on the financing pattern of the group.

- *Documents*: The project report can be written in either Chinese or English. However, you should use the same language throughout the report, including the text, tables, appendices and charts. The report should be double-spaced with a maximum length of 30 pages. Illustrate important issues with charts, figures, and tables whenever possible. You should also prepare an MS-Powerpoint file for presentation. The submitted hard-copy report should be accompanied with a CD (or floppy disk) containing the report in an MS-Word file, the Powerpoint presentation file, and all the data and spreadsheets that you used to write the report. The CD (disk) should also include a read-me file listing and explaining the data files and spreadsheets.
- *Grading*: The grading criteria of the project report are similar to those of the case report (see Case Analysis for details). However, there is a serious consequence of failing to submit any of the preliminary reports. Failing to submit a preliminary report will result in a deduction of 10 points from the maximum 40 points of your project grade. That is, if you miss the deadline of the first preliminary report, your maximum grade of the project is reduced to 30. If you fail to submit both the first and the second preliminary report by their deadlines, your maximum project grade is 20.

COURSE SCHEDULE

Week 1: February 5

Course Overview

What Determine Value?

- Bennett Stewart, "Market Myths," *Journal of Applied Corporate Finance*, Fall 1989.

Week 2: February 10 & 12

Understanding Corporate Governance: A Prerequisite to Valuation

- Stijn Claessens and Joseph Fan, 2003, "Corporate Governance in Asia: A Survey", *International Review of Finance*, forthcoming.
- Donghua Chen, Joseph Fan, and T.J. Wong, 2002, "Do Politicians Jeopardize Professionalism? Decentralization and the Structure of Chinese Corporate Boards," Working Paper, HKUST.
- Standard & Poor's, 2002, "Corporate Governance in Hong Kong."
- Case study 1: New World Development Group

Week 3: February 17 & 19

Review of Financial Mathematics

- BM 2.1, 3.1 – 3.4, 5.1 – 5.3
- Assignment

Valuation by Discount Cash Flow

- BM 4.5, 6.1 – 6.2
- Assignment

Week 4: February 24 & 26

Forecasting and Sensitivity Analysis

- BM: 10.1, 11.1 – 11.3

Searching for Company Information

- To be held on February 26 at the Library Computer Lab (LG 1332 on LG1, Library; next to Media Resources)

Week 5: March 3 & 5

Cost of Capital Estimation (1)

- BM: 3.5, 9.1 – 9.6, 19.1 – 19.3

Week 6: March 10& 12

Cost of Capital Estimation (2)

- Bond rating systems, Moody's
- Case study 2: Grand Metropolitan PLC

Week 7: March 17& 19

- Case study 3: The Boeing 777 (**Case report due on March 17**)

Valuation in Emerging Market (1)

- Tom Copeland, Tim Koller, and Jack Murrin, Valuation: Measuring and Managing the Value of Companies chapter 18, Valuation outside the U.S.
- Tom Copeland, Tim Koller, and Jack Murrin, Valuation: Measuring and Managing the Value of Companies chapter 19, Valuation in Emerging Markets

Week 8: March 24 & 26

Valuation in Emerging Market (2)

- The first preliminary group project report due on **March 26**
- Mimi James and Tim Koeller, "Valuation in Emerging Markets", McKinsey Quarterly 2000, number 4.
- Javier Estrada, "The Cost of Equity in Emerging Markets: A Downside Risk Approach", Emerging Markets Quarterly 2000.
- Paolo Mauro, "Why Worry About Corruption?", Economic Issues No. 6, mimeo, 1997
- David Beim and Charles Calomiris, *Emerging Financial Markets*, Chapter 4, Legal Foundation
- David Beim and Charles Calomiris, *Emerging Financial Markets*, Chapter 5, Information and Control
- Case study 4: China.com

Week 9: March 31 & April 2

Capital Structure (1)

- BM 17, 18

Mid-term Examination (April 2)

Week 10: April 7 & 9

Capital Structure (2)

- BM 15
- Joseph Fan, Sheridan Titman, and Garry Twite, 2003, An International Comparison of Capital Structure and Debt Maturity Choices
- Michael Pomerleano, 1998, The East Asia Crisis and Corporate Finances: The Untold Microeconomic Story, *Emerging Markets Quarterly* 2, 4. 14-27.
- Stijn Claessens, Simeon Djankov, and Giovanni Ferri, 1999, "Corporate Distress in East Asia: Assessing the Impact of Interest and Exchange Rate Shocks", *Emerging Markets Quarterly* 3, 2. 8-14.
- Stijn Claessens, Simeon Djankov, and Larry Lang, 2000, "East Asia Corporates: Growth, Financing and Risks Over the Last Decade," *Emerging Markets Quarterly*.

Week 11: April 14 & 16

- The second group project report due on **April 16**
- Cast Study 5: Du Pont

Week 12: April 21 & 23

Break (no class)

Week 13: April 28 & 30

Mergers, Acquisitions, and Restructuring (1)

- BM 33, 34
- Fred Weston et al., *Mergers, Restructuring, and Corporate Governance*, Chapter 11, *Corporate Restructuring and Divestitures*
- Case study 6: The Restructuring of the U.S. Natural Gas Industry

Week 14: May 5 & 7

Mergers, Acquisitions, and Restructuring (2)

- The third group project report due on **May 7**
- Case study 7: Time-Warner
- Robert Monks and Nell Minow, *Corporate Governance*, 2nd Edition, Blackwell, Chapter 6, pp. 350 – 361.

Week 15: May 12 & 14

Project Presentation

- The final group project report due on **May 19**

LIST OF CASES

[1] New World Development Group

[2] Grant Metropolitan PLC, Case 13 of Robert Brunner, *Case Studies in Finance*, 3rd Edition, Richard Irwin, 1999, pp. 180-197.

[3] “The Boeing 777”, Case 14 of Robert Brunner, *Case Studies in Finance*, 3rd Edition, Richard Irwin, 1999, pp. 198-215.

[4] China.com

[5] “E.I. du Pont de Nemours and Company (1983)”, in Carl Kester et al. Ed., *Case Problems in Finance*, 11th Edition, Irwin, 1997, pp. 153-164; originally *Harvard Business School case 284-062*.

[6] “The Restructuring of the U.S. Natural Gas Industry,” in Fred Weston et al., *Mergers, Restructuring, and Corporate Governance*, forthcoming.

[7] Time Inc.’s Entry into the Entertainment Industry (A), in Carl Kester et al Ed., *Case Problems in Finance*, 11th Edition, Irwin, 1997, 683-704; originally *Harvard Business School case 293-117*.

LIST OF ARTICLES

[1] Donghua Chen, Joseph Fan, and T.J. Wong, 2002, “Do Politicians Jeopardize Professionalism? Decentralization and the Structure of Chinese Corporate Boards,” Working Paper, HKUST.

[2] Stijn Claessens, Simeon Djankov, and Giovanni Ferri, 1999, "Corporate Distress in East Asia: Assessing the Impact of Interest and Exchange Rate Shocks", *Emerging Markets Quarterly* 3, 2. 8-14.

- [3] Stijn Claessens, Simeon Djankov, and Larry Lang, 2000, "East Asia Corporates: Growth, Financing and Risks Over the Last Decade," *Emerging Markets Quarterly*.
- [4] Stijn Claessens and Joseph Fan, 2003, "Corporate Governance in Asia: A Survey", *International Review of Finance*, forthcoming.
- [5] Javier Estrada, "The Cost of Equity in Emerging Markets: A Downside Risk Approach", *Emerging Markets Quarterly* 2000.
- [6] Joseph Fan, Sheridan Titman, and Garry Twite, 2003, An International Comparison of Capital Structure and Debt Maturity Choices
- [7] Mimi James and Tim Koeller, "Valuation in Emerging Markets", *McKinsey Quarterly* 2000, number 4.
- [8] Paolo Mauro, "Why Worry About Corruption?", *Economic Issues* No. 6, mimeo, 1997
- [9] Michael Pomerleano, 1998, The East Asia Crisis and Corporate Finances: The Untold Microeconomic Story, *Emerging Markets Quarterly* 2, 4. 14-27.
- [10] Bennett Stewart, "Market Myths," *Journal of Applied Corporate Finance*, Fall 1989.
- [11] David Beim and Charles Calomiris, *Emerging Financial Markets*, Chapter 4, Legal Foundation
- [12] David Beim and Charles Calomiris, *Emerging Financial Markets*, Chapter 5, Information and Control
- [13] Tom Copeland, Tim Koller, and Jack Murrin, *Valuation: Measuring and Managing the Value of Companies* chapter 18, Valuation outside the U.S.
- [14] Tom Copeland, Tim Koller, and Jack Murrin, *Valuation: Measuring and Managing the Value of Companies* chapter 19, Valuation in Emerging Markets
- [15] Robert Monks and Nell Minow, *Corporate Governance*, 2nd Edition, Blackwell, Chapter 6, pp. 350 – 361.
- [16] Fred Weston et al., *Mergers, Restructuring, and Corporate Governance*, Chapter 11, Corporate Restructuring and Divestitures
- [17] Standard & Poor's, 2002, "Corporate Governance in Hong Kong."