OBJECTIVE

Programme participants will learn to apply advanced corporate finance tools and techniques to practical situations. Advanced Corporate Finance uses lectures and case studies and focuses on two key topics: valuation and financing decisions.

Participants are assumed to have good knowledge of valuation methods (including the use of the CAPM for determining the cost of capital), capital structure concepts and basic option pricing theory.

Valuation

The programme explores how to value:
- companies and projects, using discounted cash flow analysis
- investments, using real options
- investments in emerging markets
- corporate governance and information risks at the country and firm level
- firms in financial distress and bankruptcy

Financing Decisions

The programme surveys a number of key financial decisions faced by companies, including:
- optimal capital structure
- corporate liquidity issues
- raising equity and debt capital in global markets; negotiating with capital suppliers
- mergers and acquisitions
- financial distress, default, and bankruptcy

CLASS PREPARATION

This is a very intensive course. The course covers a large amount of material in significant depth over a very short period of time. It is important that students are well prepared for each class. We will cover a lot of cases in one week and students should spend sufficient time before the start of the course reading all the materials (including the cases) and attempting to solve the cases. Cold calling will be the main pedagogical method and will be used for all cases.

We will be working through nine cases. To make these cases as informative as possible in a classroom setting, each student should read through all the cases and case questions (included in the folder) in advance of the programme.

FIRST CLASS PREPARATION

You should come to the first class fully prepared with your solutions for the first case (the Case of the Unidentified Industries). Cold calling will be actively used.

In addition, you should revisit the appropriate basic corporate finance knowledge by reading chapters of Berk-DeMarzo (BDM): chapters 6, 7 (in particular 7.2), 9 (in particular 9.3), 18.1-18.3.
Read/skim other parts of the book referred in these chapters as needed. Also, read over the Darden note: Methods of Valuation in Mergers and Acquisitions, included in your pack.

CLASS ATTENDANCE AND PARTICIPATION

Class participation is mandatory. You will be asked cold call questions during classes. Your answers will count towards class participation for the course. You are encouraged to ask questions in class (given limited amount of time and the size of the class, your professor may not have time to answer all questions in class).

STUDY GROUPS

Apart from the very first case on Monday, all other cases should be done in groups. Questions guiding the analysis of all cases that will be discussed in this programme are included in this outline. The course folder contains all cases. Your group should come fully prepared to discuss and explain your solution of each case. Because this course is very intensive, you will have to solve all the cases in the afternoon and evening of each day (from Monday to Thursday including).

TEXTBOOK, COURSE FOLDER, MATERIALS AND READINGS

Textbook:


Case Questions:

- Case questions are given in this outline

Programme Readings (all of these readings are included in your folder in the following order):

- The Case of the Unidentified Industries (HBS-9-296-049)
- Darden Note: Methods of Valuation in Mergers and Acquisitions (UVA-F-1274)
- Adecco SA’s Acquisition of Olsten Corp case (HBS-9-201-068)
- HBS note: Capital Projects as Real Options (HBS 9-295-074)
- Arundel Partners: The Sequel Project case (HBS 9-292-140)
- Diageo, plc case (HBS-9-201-033)
- Polaroid, 1996 case (UV 0007)
- Darden Note: Valuation in Emerging Markets (UVA-F-1455)
- The Hostile Bid for Red October case (HBS-9-296-084)
- Globalizing the Cost of Capital and Capital Budgeting at AES case (HBS 9-204-109)
- Iridium LLC case (HBS-9-200-039)
- UAL, 2004: Pulling Out of Bankruptcy case (HBS-9-205-090)
**GRADING**

Your course grade will be determined by your class participation (25%), and your exam (75%).

**COURSE ETIQUETTE**

Laptop computers may be used in class as long as they are used for note-taking or to support class participation. As a result, open laptops are taken as an indication of students’ willingness to participate in class discussion (and substantially increase the possibility of this student being cold called). Cellular phones, PDAs, etc. should not be used in class.

Punctuality is important. Please be strictly on time for the beginning of each class. Tardiness will negatively affect your class participation and therefore grade.

Students are expected to behave with integrity in all aspects of the course.

**EXAMS**

The exam will be given on **9th January 2010**.  
The exact time and place are to be confirmed.  
The exam is closed book.

**YOUR PROFESSOR**

Ilya Strebulaev is an Associate Professor of Finance at the Graduate School of Business, Stanford University, and a Visiting Associate Professor of Finance at London Business School. He has been teaching case-based Corporate Finance MBA course at Stanford GSB for five years and won the Stanford’s MBA 2009 Distinguished Teaching Award (awarded annually to one faculty member at Stanford GSB), having been short-listed for the award in the two prior years as well. Ilya’s research focuses on corporate finance, capital structure, and credit risk. His most recent work has examined issues of dynamic capital structure, impact of macroeconomic factors on corporate decisions and defaults, as well as zero-leverage behaviour and financial distress. His research has been published in the top journals such as *Review of Financial Studies, Journal of Finance, and Journal of Financial Economics*. Ilya received the 2004 Trefftzs WFA award for the best paper as well as the First prize of the 2007 Brattle Award for the best corporate paper published in the *Journal of Finance*.

Ilya graduated from the London Business School with a doctorate in Finance in 2004. He also holds degrees from Lomonosov Moscow State University (B.Sc. Math. Economics) and the New Economic School, Moscow (M.A. Economics).

**LOGISTICS**

With *all* questions on logistics please contact either Stefania Uccheddu (office P201) or the MBA office.
The Case of the Unidentified Industries (HBS-9-296-049)

Case Questions

This is a warm-up case with which we will start our course. Although it may seem initially rather simple, it actually contains a number of deep and subtle issues and will allow us to introduce all the topics we will be covering this week.

Make sure you solve it in advance and come to the first class ready to explain and defend your proposed solution.

1) For each of the 11 sets of financial data, identify the industry represented.

2) Explain the distinctive financial characteristics associated with each industry.

3) What financial characteristics are most useful/typical in analysing corporate performance?
Case Questions

1) How has Adecco been able to outperform its rivals in the staffing industry? What is the strategic and economic rationale for its acquisition of Olsten?

2) Evaluate Olsten’s strategic and financial conditions as of mid-1999, in particular its funding needs and resources.

3) Based on Adecco’s pro forma estimates of the staffing business of Olsten in Exhibit 13, what is your estimate of total enterprise value? For this calculation, make the following assumptions:
   a. Evaluate the valuation from the perspective of Adecco US
   b. Assume the acquisition was completed as of January 1, 2000
   c. Evaluate enterprise value at the long-term capital structure for Olsten; i.e., 20% debt and 80% equity
   d. The estimated EBIAT (Earnings before interest but after taxes, also called operating earnings less taxes) was arrived at without deducting the amortization of goodwill
   e. Assume that Olsten’s US rivals, Kelly and Manpower, had a debt beta of 0.2
   f. For this calculation of total enterprise value do not consider (1) any Olsten debt that might be assumed by Adecco, (2) any payments that Adecco might need to make to minority shareholders of some of its subsidiaries, (3) any special tax benefits that can accrue to Adecco SA through its ability to charge Adecco US royalties.

4) Now, let’s factor in several other components/nuances of an Adecco valuation:
   a. If Adecco were to assume $750 million of Olsten debt, how would this affect how much they would pay for the equity of Olsten’s staffing business?
   b. Some of the enterprise value calculated above in Question 3 is actually “owned by” minority shareholders in some of Olsten’s subsidiaries. How would this affect how much Adecco would pay for the equity of Olsten’s staffing business?
   c. Page 7 in the case describes a method whereby Adecco US could make royalty payments to Adecco SA. What is the valuation impact of this “tax market imperfection”? To simplify this analysis, assume that royalties are 1.5% of revenues and value the net tax savings from the perspective of the US firm (Adecco US).

5) As Adecco, how much would you bid for Olsten? Why? How would you convince the Olsten board to accept your offer?

6) As the Olsten board, how would you evaluate the competing offers? How might the Olsten family’s perspective differ from that of the other board members?
Case Questions

You are considering investing in the business of purchasing movie sequel rights proposed by Arundel Partners. Before you commit funds, you must come up with an assessment of the value of the venture. To do so, you have to answer the following set of questions.

1) To get started with the case, draw a timeline that shows the key decision points and times at which cash flows associated with the project occur.

2) Why do the principals of Arundel Partners think they can make money buying movie sequel rights? What is the source of value creation if any? Why do the partners want to buy a portfolio of sequel rights to all films in advance rather than negotiating film-by-film to purchase the rights later?

3) Estimate the per-film value of a portfolio of sequel rights using the data in exhibits 6, 7, and 9. You can assume that this data is a good representation of an "average" year of film production.

Use three methods of valuing the sequel rights.

a. First, do a simple DCF valuation. In other words, simply compute the value of the portfolio at the time Arundel pays for the rights using the traditional NPV approach, ignoring any embedded options. Use a cost of capital of 12% per annum. Remember, that under the traditional DCF valuation, the expected cash flows are used. Based on this method, how much should Arundel be willing to pay per sequel right?

b. Second, recognize that owning the right to a sequel does not obligate you to produce the film if you find out that the original is a flop. Take this into account by using a decision tree approach that recognizes that you will not make every sequel to which you own the rights. One way to begin is to assume that you can tell which sequels will be positive NPV before you make them. Use the data in exhibit 7 to revalue the sequel rights assuming that you will only exercise the rights for those sequels that have a positive NPV. Be sure to include the fact, however, that you must purchase the rights to all sequels, not just the ones that you eventually produce. Continue to assume that the cost of capital is 12%. What is the implied value per right?

c. Third, value the sequel rights using a real-options approach based on the Black-Scholes option pricing formula. Assume that the appropriate risk-free rate is 6% per annum. Map the other variables in the problem into the real options framework. You can assume that all of the uncertainty in knowing about the potential success of a sequel is resolved immediately after the original film is released. This is true even though there is an additional time lag until the sequel is actually released.

4) How much are the rights to sequels worth? How much should Arundel offer to pay for sequel rights? What problems or disagreements would you expect Arundel and a major studio to encounter in the course of the business relationship described in the case? What types of contractual provisions would you suggest Arundel insist on?
Diageo plc (HBS 9-201-033)

Case Questions

1) Describe briefly Diageo's business, putting particular emphasis on the potential sources of risk, and your evaluation thereof. Identify major sources of risk for equityholders and for debtholders.

2) Describe Diageo's current approach to managing its capital structure. What are the key variables that guide its capital structure policy?

3) What factors should Diageo consider in determining its capital structure? What information would you collect and what analyses would you conduct in order to determine the appropriate level of gearing?

4) How does the Treasury Group's simulation work? What aspects of Diageo's business does it capture? What does it ignore? What key assumptions does it make? How could you improve the model to adjust any missing factors?

5) What are the managerial implications of the summary results shown in Figure 2 of the case? As Ian Cray, what questions would you ask the Treasury team in reviewing their work? What should Cray recommend for Diageo's gearing when it becomes a pure beverage alcohol business? Frame your recommendation in terms of a target level of interest coverage or a target bond rating.
Polaroid Corporation, 1996 (UV 0007)

Case Questions

1) What are the main objectives of the debt policy that Ralph Norwood must recommend to Polaroid’s board of directors?

2) What financing requirements do you foresee for the firm in the coming years? What are the risks associated with Polaroid’s business and strategy? In your view, what are Polaroid’s peer firms?

3) Drawing on the financial ratios in case Exhibit 9, how much debt could Polaroid borrow at each rating level? In particular, find the unused debt capacity of Polaroid for each rating, from AAA to B. (To answer this question, assume that the market-to-book ratio of Polaroid remains 3 independent of credit rating. Discuss this assumption) What EBIT coverage ratios would result from the borrowings implied by each rating category?

4) Using Hudson Guaranty’s estimates of the costs of debt and equity in case Exhibit 11, which rating category has the lowest overall cost of funds? Do you agree with Hudson Guaranty’s view that equity investors are indifferent to the increases in financial risk across the investment-grade debt categories?

5) Is Polaroid’s current maturity structure of debt appropriate?

6) What should Ralph Norwood recommend regarding:

   a. The target bond rating;

   b. The level of flexibility of reserves;

   c. The mix of debt and equity;

   d. The maturity structure of debt;

   e. And any other issues you believe should be brought to the attention of the CEO and board?
The Hostile Bid for Red October (HBS-9-296-084)

Case Questions

1) Strategically, does Red October fit with Koloss? Why is it an attractive target? What does it do for Menatep Bank?

2) Is the company undervalued at $5 per share, the "rough" price before the takeover attempt?

3) Using Exhibit 8a projections and the equity cost calculated in Exhibit 8b, how would you value the shares? Is this cost of equity capital estimate reasonable? What would happen to the value if you were to use the 50 percent opportunity cost mentioned in the case? Are the projections reasonable?

4) What is Koloss? Menatep's bidding strategy? Red October's strategy in response?

5) What should management do now that K/M has raised the tender offer to $9.50 per share?
Globalizing the Cost of Capital at AES (HBS-9-204-109)

Case Questions

1) How would you evaluate the capital budgeting method used historically by AES? What is good and bad about it?

2) If Venerus implements the suggested methodology, what would be the range of discount rates that AES would use around the world?

3) Does this make sense as a way to do capital budgeting?

4) What is the value of the Pakistan project using the cost of capital derived from the new method? If this project was located in the U.S., what would its value be?

5) How does the adjusted cost of capital for the Pakistan project reflect the probabilities of real events? What does the discount rate adjustment imply about expectations for the project because it is located in Pakistan and not the U.S.?
Iridium LLC (HBS-9-204-109)

Case Questions

Your team of experts has been brought in to do a post-mortem on the Iridium experience. Prepare a discussion to address the following questions.

1) Describe briefly Iridium's financial strategy. (No need to assess it at this point). How did Iridium justify its target debt-to-total book capitalization ratio of 60%?

2) Assess Iridium's financial strategy. In your view, did it have the wrong target capital structure, issue the wrong kind of capital, or issue capital in the wrong sequence?

3) Based on DCF analysis and using the forecast in Exhibit 5, determine Iridium's enterprise value, equity value and per share value. (Make sure to explain how you deal with preferred equity and warrants). What are the important determinants of your DCF valuation of Iridium? How confident are you in your valuation? Compare your estimate to Iridium's stock price at the end of 1998.

4) In 1991, Motorola incorporated Iridium as a separate company, financed with project debt rather than corporate debt. What are the pros and cons of this decision? Would you have done the same? Why or why not?

5) What were the major factors that caused Iridium to fail?

6) What lessons for the financing of large green field projects do you draw from Iridium's experience?

Note: There is a typo in Exhibit 5: in 2000 Total Debt should be 3,437 not 4,437.
UAL: Pulling out of Bankruptcy in 2004

Case Questions

1) Why did UAL file for bankruptcy protection in December 2002?

2) What is the rationale for allowing companies to restructure their debts and operations under Chapter 11 bankruptcy protection?
   a. What is the role of the “automatic stay”, which prevents creditors from pursuing their claims to defaulted borrower’s assets outside of bankruptcy court?
   b. What is the role of ‘debtor-in-possession' financing for companies operating under Chapter 11 protection? Why are DIP loans granted seniority to firms’ pre-petition obligations?

3) What are the incentives of the different parties involved in restructuring UAL? What are the incentives of the firm’s management? Secured creditors? DIP lenders? Unsecured creditors? Employees?

4) What are the important costs of financial distress that UAL is facing? How would these costs of financial distress vary across different industries?

5) Why has leverage in the airline industry been high relative to other industries? What leverage would you choose after emerging from bankruptcy?

6) As UAL, would you continue making required contributions to your pension plans?
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<th>Time</th>
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| 08.15–11.00 | **Introduction and Welcome**  
**Case discussion**  
Case of the Unidentified Industries  
**Topic**  
Capital Budgeting  
Free Cash Flows  
Weighted Average Cost of Capital (WACC) Estimation  
Review of DCF Estimation Methods |
| 12.45-15.30 | Other Valuation Methods: Multiples; APV; M&A Considerations  
Real Options |
| 15.30-08.15 | **Prepare your group solution of two cases:**  
Adecco SA’s Acquisition of Olsten Corp  
Arundel Partners  
BDM, Ch. 22, 28.1-28.4 |

**Group Study**
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<td><strong>Prepare your group solution of two cases:</strong></td>
<td>Diageo plc case, Polaroid case, BDM, Ch. 14, 15, 24</td>
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<td><strong>Topic</strong>&lt;br&gt;Valuation in Emerging Markets  &lt;br&gt;International Corporate Governance &lt;br&gt;Assessing International Risks</td>
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<td><strong>Prepare your group solution of two cases:</strong>&lt;br&gt;UAL, 2004 case  &lt;br&gt;Iridium LLC case  &lt;br&gt;BDM, Ch. 16</td>
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## ADVANCED CORPORATE FINANCE 2010

### DETAILED PROGRAMME OUTLINE

**Day 5: Friday**

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