1231-3340 - CORPORATE FINANCE
Falls 2001-2002

Instructor: Efrat Tolkowsky
Class Schedule: Monday 12:45 – 15:30  Room: 253
Office: 457
Office Hours: Before and after class, or by appointment
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Course Description:
The course covers the major topics in corporate finance and financial management including capital budgeting, cost of capital, capital structure, dividend policy, mergers and acquisitions, and financial distress. The objective of the course is to provide an understanding of both the theory of corporate finance and how it applies to the "real" world. Every effort will be made to integrate current business news into the presentation and discussion of the material.

Required and Recommended Materials:
The textbook for the course is

There are also four required HBS cases that are available in a course pack in the bookstore:
"The Super Project"
"Marriott Corporation: The Cost of Capital"
"American Home Products Corp."
“Dividend Policy at FPL Group"
“Gulf Oil”

In addition, required readings are a collection of articles from:

Student will submit reading reports on each of the required reading.

Course Requirements
The course requirements consist of both group and individual assignments. Groups should consist of 3-4 students, and should be organized as early as possible during the semester.

Group assignments:
• Each group will be responsible for preparing all the cases, which will be discussed extensively in class. A case summary of no more than 3 pages (plus appendices) should be handed in at the beginning of the class session in which the case is discussed.

The individual assignments:
• Reading reports ill be submitted at the beginning of the appropriate class,
• Periodical exercise mentioned above. The exercise will be submitted a week after assignment.
• Final Exam.
Students who would not get a passing grade on the final exam will fail the course. Students who will submit less than 85% of homework exercise will have their final grade reduced by 20%.

Finally, students are expected to contribute, in a constructive manner, to classroom discussions. The assigned reading should be done before the corresponding class session, and it is also a good idea to read the Wall Street Journal or the business section of the Haretz.

Grading Policy:
The final grade will be calculated as follows:
Cases/Reading reports 25%  
Class Participation 15%  
Final 60%  

Course Outline
This outline is preliminary and subject to change. The due dates of all assignments will be announced in class, however the cases are listed in the approximate session when they will be due. RWJ refers to Ross, Westerfield, and Jaffe, Corporate Finance, and SC refers to Stern and Chew, The New Corporate Finance, Where Theory Meets the Practice. The RWJ readings are required, and the SC are recommended readings and SCREQ are required. Readings should be done prior to the class session in which the material is discussed.

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<tr>
<th>Session</th>
<th>Topics</th>
<th>Assignments</th>
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| Class 1 | Introduction  
Course overview | | |
| Class 2 | Capital Budgeting I  
Accounting and cash flows  
Estimating cash flows  
Why NPV? | RWJ: Chapters 2, 7.1-7.2. Q: 2.7, 2.8  
Students not familiar with the subjects in chapters 4-5, please read and learn!!!!!! |
| Exercise 1 | | |
| Class 3 | Capital Budgeting II  
NPV vs. IRR  
Alternative investment rules  
Investments of unequal lives | RWJ: Chapter 6. Q: 6.15, 6.16, 6.17, 6.18; |
| Class 4 | Capital Budgeting II (cont.) | |
| Exercise 2 | | |
| Class 5 | Capital Budgeting III  
Inflation  
Strategy  
Scenario/sensitivity analysis | RWJ: Chapter 7.3, 8.Q: 7.15, 7.18 7.23 7.26 7.27. 8.3, 8.6, 8.9, 8.11, 8.12, 8.13, 8.14.  
Student should read and learn section 7.4.  
| Class 6 | Corporate Finance  
Corporate organization  
Goals of the corporation  
Agency costs and incentives | RWJ: Chapter 1  
SC: “The modern industrial revolution, exit, and the failure of internal control systems”  
SC-optional: “Continental Bank roundtable on the role of corporate boards on the 1990s” |
| Exercise 3 | | |
| Class 7 | Capital Budgeting IV | Case: The Super Project |
| Class 8 | Long-Term Financing  
Debt, equity, and preferred stock  
SC: "Raising Capital: Theory and Evidence" (277-293)  
SC-optional: “Initial Public Offerings” (309-317) |
| Exercise 4 | | |
| Class 9 | Long-Term Debt  
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<th>Class</th>
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<td>11</td>
<td><strong>Review of Risk and Return</strong>&lt;br&gt;Portfolio theory and diversification&lt;br&gt;The CAPM</td>
<td></td>
<td>RWJ: Chapters 9, 10, 11. Q: 9.8, 9.9, 9.11, 9.17, 10.24, 10.29, 10.31, 10.33, 10.41. 11.11.8. O: “In Defense of Beta”</td>
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<td>12</td>
<td><strong>Risk, Return and the Capital Budgeting</strong>&lt;br&gt;Equity, debt and preferred stock&lt;br&gt;WACC</td>
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<td>RWJ: Chapter 12. Q: 12.9, 12.10, 12.13, 12.15.</td>
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<td>13</td>
<td><strong>Cost of Capital II</strong></td>
<td>6</td>
<td>Case: Marriott Corporation</td>
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<td>17</td>
<td><strong>Capital Structure III</strong>&lt;br&gt;Valuation with leverage APV, FTE and WACC</td>
<td>8</td>
<td>RWJ: Chapter 17. Q: 17.4, 17.5, 17.9, 17.13, 17.14, 17.16. The students are requested to read Appendix 17A RWJ. SC: On Financial Architecture: Leverage, Maturity, and Priority” (210-224)</td>
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<tr>
<td>19</td>
<td><strong>Dividend Policy I</strong>&lt;br&gt;Irrelevance revisited Signaling and taxes Stock dividends and stock splits</td>
<td>9</td>
<td>RWJ: Chapter 18. Q: 18.3, 18.7, 18.11, 18.14 and 18.15. SC: ”Does Dividend Policy Matter” (pp.137-142)</td>
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<td>20</td>
<td><strong>Dividend Policy I</strong> Cont.</td>
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Exercises:
- Exercise 5
- Exercise 6
- Exercise 7
- Exercise 8
- Exercise 9
- Exercise 10
| Class 21 | Mergers and Acquisitions II  
The empirical evidence Takeover defenses | RWJ: Chapter 29  Q: to be announced  
SC: "The Takeover Controversy: Analysis and Evidence" (pp.351-377) |
|--------|---------------------------------------------------|---------------------------------------------------------------|
| Class 22 | Capital Structure V  
Exercise 11 | Case: American Home Products Corp. |
| Class 23 | Example: Dividend Policy, Repurchase and Tax benefits of Debt | Water Product Company Example |
| Class 24 | Dividend Policy II  
Exercise 12 | SC: "The dividend cut’ "Heard around the world”: the case of FPL” (235-246)  
Case: FPL |
| Class 25 | Options  
Option pricing  
Options in corporate finance | RWJ: Chapter 21. Q: to be announced |
| Class 26 | Warrants and Convertible Bonds  
Valuation  
Reasons for issuance | RWJ: Chapter 22. Q: to be announced  
SC: "The Case for Convertibles" (pp.194-202) |
| Class 27 | Mergers and Acquisitions II  
Exercise 13 | Case: Gulf Oil |
| Class 28 | Conclusion  
Course review | |
| Class 29 |  | |

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*Exercise*
Questions for Cases
"The Super Project"

1. What are the relevant cash flows for General Foods to use in evaluating the Super Project? In particular, how should management deal with issues such as:
   i. Test-market expenses?
   ii. Overhead expenses?
   iii. Erosion of Jell-O contribution margin?
   iv. Allocation of charges for the use of excess agglomerator capacity?

2. How attractive is the investment as measured by various capital budgeting techniques (i.e., accounting rate of return, payback period, internal rate of return, net present value)? How useful are each of these measures of investment attractiveness?

3. How attractive is the Super project in strategic and competitive terms? What potential risks and benefits does General Foods incur by either accepting or rejecting the project?

4. Should General Foods proceed with the Super project? Why or why not?

"Marriott Corporation: The Cost of Capital"

1. Are the four components of Marriott’s financial strategy consistent with its growth objective?

2. How does Marriott use its estimate of its cost of capital? Does this make sense?

3. What is the weighted average cost of capital for Marriott Corporation?:
   i. What risk-free rate and risk premium did you use to calculate the cost of equity?
   ii. How did you measure Marriott’s cost of debt?
   iii. Did you use arithmetic or geometric averages to measure rates of return? Why?

4. What type of investments would you value using Marriott’s WACC?

5. If Marriott used a singles corporate hurdle rate for evaluating investment opportunities in each of its line of business, what would happen to the company over time?

6. What is the cost of capital for the lodging and restaurant divisions of Marriott?
   i. What risk-free rate and risk premium did you use in calculating the cost of equity for each division? Why did you choose these numbers?
   ii. How did you measure the beta of each division?

7. What is the cost of capital for Marriott’s contract services division? How can you estimate its equity cost without publicly traded comparable companies?
"American Home Products Corp."

1. How much business risk does American Home Products face? How much financial risk would American Home Products face at each of the proposed levels of debt shown in case Exhibit 3? How much potential value, if any, can American Home Products create for its shareholders at each of the proposed levels of debt?
2. What capital structure would you recommend as appropriate for American Home Products? What are the advantages of leveraging this company? The disadvantages? How would leveraging up affect the company’s taxes? How would leveraging up affect the company’s taxes? How would the capital markets react to a decision by the company to increase the use of debt in its capital structure?
3. How might American Products implement a more aggressive capital structure policy? What are the alternative methods for leveraging up?
4. In view of AHP’s unique corporate culture, what arguments would you advance to persuade Mr. Laporte or his successors to adopt your recommendation?

“FPL”

1. Why do firms pay dividends? What, in general, are the advantages and disadvantages of paying cash dividends?
2. What are the most important issues confronting the FPL Group in May 1994?
3. From FPL’s perspective, is the current payout ratio appropriate? Would a higher payout ratio be more appropriate? A lower payout ratio?
4. From an investor’s perspective, is FPL’s payout appropriate?
5. As Kate Stark, what would you recommend regarding investment in FPL’s stock – buy, sell, or hold?

“Gulf Oil”

1. Evaluate the economics of Gulf’s exploration and development program in net present value terms. How do gulf’s outlays of exploration and development compare to the cash returns Gulf generates from these activities?
2. When Gulf was placed on the auction block, a minimum bid level was established at $70 per share. Yet only a few months before, gulf was trading in the $40 range. How could Golf become so much more valuable in such a short period of time?
3. How did Boone Pickens stampede Gulf into a sale? Even if the Pickens group were totally successful in their last tender offer, they would only control 21% of Gulf’s stock. Why did the Gulf Investors’ Group limit its total offer to 21% of the equity? Could they have afforded to buy more? Do you think reincorporation influence the raider’s strategy? Why?
4. If you were one of the prospective Gulf buyers called to Pittsburgh, *how much would you bid* to acquire the Gulf Oil Corporation? How does your knowledge of the motives and financial position of the other bidders influence your offer? How would the way in which you finance the takeover of Gulf influence the way you would run Gulf after the ta