

CASE STUDIES IN FINANCE

Managing for Corporate Value Creation



ROBERT F. BRUNER



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Managing for Corporate Value Creation

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*To these excellent teachers
with whom it has been my high privilege to study:*

*Anthony G. Athos
Marjorie W. Bruner
C. Roland Christensen
Joel Fleishman
Peter J. Gomes
John H. McArthur
David W. Mullins, Jr.
William W. Sihler*

*What we call the beginning is often the end
And to make an end is to make a beginning.
The end is where we start from.*

T.S. Eliot, "Little Gidding"

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Robert F. Bruner is presently Associate Professor of Business Administration, Darden Graduate School of Business, University of Virginia. Published in such journals as *Journal of Financial Economics*, *Journal of Financial and Quantitative Analysis*, *Journal of Accounting and Economics*, and *Journal of Money, Credit, and Banking*, his research has dealt mainly with the effects of the various forms of corporate restructuring. Three graduating classes of M.B.A. students have recognized him for excellence in case teaching; and he is a recipient of the First Wachovia Award for Faculty Excellence in case writing. He has consulted for various industrial corporations and financial institutions.

Foreword

by John H. McArthur,
Dean, Harvard Business School.

One should never declare oneself to be “objective” regarding the work of a former student. Let us admit a truth: The teacher’s natural tendency is to lay claim to any flashes of genius in the student’s later intellectual life—and, just as naturally, to deny responsibility for any shortcomings or disappointments over the course of that same life.

In that spirit, I’m happy to take full vicarious responsibility for *Case Studies in Finance*. In the early 1970s, Robert F. Bruner was a student and a friend of mine in the MBA Program at the Harvard Business School, where he subsequently earned his doctorate. As he immersed himself ever more deeply in the rich and strange world that is corporate finance, Bob soon evidenced the mix of personal qualities that would come to serve him well: tenacity, patience, skepticism, iconoclasm, and good will.

Those same qualities have directed the research behind the following 47 cases. The case materials are, at once, rigorous and engaging. They meet the essential criteria for good cases—that is, they convey complexity without confusion; they initiate the questioning process, rather than ending it; they convey multiple perspectives with clarity and force.

Collectively, it should be noted, these cases describe a world greatly changed from the one that Bob first began to analyze in the 1970s. In the last decade and a half, we have had to invent an entirely new vocabulary just to keep up with the amazing changes in corporate finance and the world economy. Fifteen years ago, how many of us could have defined leveraged buyouts, swaps, floating-rate notes, convertible Eurobonds, exchangeable preferreds, junk bonds, currency-linked bonds, zero-coupon bonds, et cetera.

For two reasons, therefore, those of us in business education are fortunate indeed to have a researcher of Bob Bruner’s caliber involved in substantive and systematic case research. First, of course, his efforts help explain our field to ourselves. More important, they provide a key point of entry for tomorrow’s business practitioners. Finance (like all other fields of inquiry in business) can and must be brought to life for managers-in-training, and case research and teaching are absolutely vital tools in that effort. These tools must be kept sharp and up to date. Happily, *Case Studies in Finance* is both well honed and bracingly contemporary.

Preface

The inexplicable is all around us. So is the incomprehensible. So is the unintelligible. Interviewing Babe Ruth¹ in 1928, I put it to him "People come and ask what's your system for hitting home runs—that 'so?" "Yes," said the Babe, "and all I can tell 'em is I pick a good one and sock it. I get back to the dugout and they ask me what it was I hit and I tell 'em I don't know except it looked good."

Carl Sandburg²

Good judgment comes from experience. Experience comes from bad judgment.

Walter Wriston

ORIENTATION OF THE BOOK

Excellence is hard to pursue and harder to teach. This book has its origins in my work with senior corporate executives on the problem of creating corporate value for their shareholders through wise investment and financing decisions. I found that understanding value creation is often a larger barrier for many managers than is deciding what to do to create that value. Coincidentally, I assumed teaching responsibilities in corporate finance at Darden and found the students to have a healthy appetite for the concepts and practice of value creation. With both clienteles in mind, I searched more and more widely for case teaching material only to discover that many of my favorite cases had been written before the revolution in strategic planning of the mid-1970s or the sea-change in capital markets occurring in 1979.³ I believed this was a major shortcoming, for value

¹George Herman "Babe" Ruth (1895–1948) was one of the most famous players in the history of American baseball, leading the league in home runs for 10 straight seasons, setting a record of 60 home runs in one season, and hitting 714 home runs in his career. Ruth was also known as the "Sultan of the Swat."

²Carl Sandburg, "Notes for a Preface," in *Harvest Poems* (New York: Harcourt Brace Jovanovich, 1960), p. 11.

³These events coincided roughly with the publication of William Fruhan's *Financial Strategy* (Homewood, Ill.: Richard D. Irwin, 1979), the first textbook devoted to the subject of value creation. Teachers in this area owe a large debt to Fruhan.

creation is nothing if it is not a concept about markets: Consequently, I decided to write cases emphasizing value creation with a somewhat broader, markets-oriented scope; over 90 cases have emerged from this program. These cases were tested in executive and MBA classroom settings where this orientation proved successful. The cases in this book are a cross-section of that case writing program, augmented by successful cases written by friends and colleagues.

What the value creation approach means is that in every case there is an implicit or explicit *valuation problem or opportunity to discuss value*. These problems and opportunities may arise from an analysis of the firm's competitive situation, the capital market environment and the requirements of shareholders or creditors, or from an analysis of the financial and operating policies of the firm. Many of these cases are amenable to applications of modern finance theory or to insights from the economics of industrial organization.

After the concepts have been applied and the analyses completed, the manager must decide and act. I have tried to preserve a pragmatic managerial action-oriented perspective in these cases. This, I believe, is what separates a case study from an elaborate textbook problem. Students and instructors will wrestle with the difficulties of the administrative point of view in two ways. First, managers know that information is seldom complete: there is rarely enough or precisely the right kind. This means that, in practice, finance concepts and formulas are rarely cleanly applied; more often, they point the analyst in a certain direction, rather than give an answer. Second, all formulas are simplistic abstractions of reality; what matters is the choice of values one inserts into the formula. Most of the cases emphasize the importance of good judgment, as opposed to simple mastery of techniques. The "how" of good judgment is, as Babe Ruth tells us, often hard to rationalize; however, growth in judgment, as Wriston says, can be helped by active experimentation. I encourage students and instructors to exploit opportunities to exercise judgment.

THE CASE OFFERING AND INTENDED AUDIENCE

The 47 cases I have selected for this book have a number of attributes, which professors and students should find desirable. First, about 90 percent of the cases are set in the 1980s, thus affording contemporary relevance—an acute pedagogical issue since the era of capital market volatility began in 1979.⁴ Second, the case offering affords the exercise of both basic and advanced technical skills. Third, the cases are supported by a data diskette available from Irwin—students familiar with Lotus® 1-2-3® will be able to advance quickly to deeper analytical insights. Fourth, the offering includes several cases with explicit or implicit

⁴The other 10 percent of cases (i.e., those set before 1980) were chosen because of the unusual or classic nature of the problem. For instance, the Du Pont case, set in 1909, was chosen because it deals with the world of no taxes often cited in financial theories.

international perspectives. And finally, virtually all of the cases demand managerial judgment—the administrative point of view can be ignored all too easily. My experience in teaching these cases to managers and degree students is that they provide rich mediums for discussion. The primary target for this volume is the first- or second-level case course in corporate finance.

PLAN OF THE BOOK

The cases may be taught in many different sequences. The sequence indicated by the Table of Contents corresponds to the outline of the introductory finance course at Darden. The cases are clustered into concept modules, each with a particular orientation:

1. Setting Some Themes. Disney and Peter Lynch introduce basic concepts of value creation and capital market efficiency that appear repeatedly throughout a case course. The numerical analysis required is relatively light; the synthesis of many case facts is a challenge.

2. Financial Analysis and Forecasting Funds Needs. These cases introduce foundation analytical techniques, including financial ratios, breakeven analysis, financial statement forecasting (both by percent of sales, and T accounts), and cash-flow forecasting. These cases emphasize the critical assessment of forecast assumptions and the need for sensitivity analysis.

3. Cost of Capital. This module begins by introducing the cost of capital as an opportunity cost—using the unusual setting of a not-for-profit corporation.⁵ The second case bears on the need for risk adjustment of hurdle rates. And the third case exercises the computation of cost of equity.

4. Capital Budgeting and Resource Allocation. The thrust of these cases is the evaluation of individual investment opportunities and the assessment of entire capital budgets. The first case is a simple review of analytical techniques. The next several cases concern the evaluation of new products, plant expansion, new technology, and a rent-versus-buy decision. Next, synergies among projects are evaluated for isolated projects and then in the context of a full capital budget. Finally, the module ends with a DCF valuation of a merger target.

5. Management of Shareholders' Equity. This module seeks to develop practical principles about dividend policy, share buybacks, and share issues by developing financial concepts about dividend irrelevance, value conservation, signaling, investor clienteles, bonding and agency costs.

6. Corporate Debt Policy. Here the focus of the module is on the setting of target capital structures. Prominent issues are: the use and creation of debt tax shields, the costs of financial distress, the role of industry economics and

⁵Many students are interested in not-for-profit businesses. It is important to illustrate the applicability of basic financial concepts in this area. And as it happens, the not-for-profit setting helps students develop an intuitive understanding of opportunity costs.

technology, and the influence of corporate competitive strategy and the trade-offs between debt policy, dividend policy, and investment goals.

7. Financing Tactics and Instruments. While the preceding two modules are concerned with the establishment of high-level financial strategy, this module addresses a range of tactics a firm might use to implement that strategy. Included are domestic and international debt offerings, swaps of various types, recapitalizations, loan guarantees, warrants, and convertibles. With these cases, students will exercise techniques in securities valuation, including the use of option pricing theory.

8. Mergers, Acquisitions, and Restructurings. This module is intended to exercise the full range of concepts and skills introduced in the preceding cases. The core concept emphasized here is value creation, though the potential sources of value cover all operating and financial policies. Included in the module is a merger negotiation exercise (Hybritech, Inc. (A))—the counterpart case (Eli Lilly and Company) is separately available, as is a detailed examination of the merger terms actually negotiated (Hybritech, Inc. (B)).

SUPPLEMENTS

In addition to the diskettes available for student use, this casebook is accompanied by an instructor's manual of over 600 pages in length. The teaching note for each case includes suggested assignment questions, a hypothetical teaching plan, detailed case analysis, and a chart of case subjects to help the instructor design a course or plan case sequences.

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All these acknowledgments notwithstanding, I am responsible for any errors which may remain, and welcome comments and suggestions for enhancement.

Robert F. Bruner

⁷Some of these executives have shifted employers since the cases were written. For simplicity, I recognize them here with their original employers.

Note to the Student: How to Study Cases

The credit belongs to the man¹ who is actually in the arena—whose face is marred by dust and sweat and blood . . . who knows the great enthusiasms, the great devotions—and spends himself in a worthy cause—who at best if he wins knows the thrills of high achievement—and if he fails, at least fails while daring greatly—so that his place shall never be with those cold and timid souls who know neither victory nor defeat.

Theodore Roosevelt²

The lessons most worth learning all come from taking a stand. From that truth flows the educative force of the case method. In the typical case, the student is projected into the position of an executive who must do something in response to a problem. It is this choice of what to do that constitutes the executive's "stand."³ Over the course of a career, an executive who takes stands gains wisdom. If the position proves to provide an effective resolution of the problem, so much the better for all concerned. If it does not, however, the wise executive analyzes the reasons for the failure and may learn even more than from a success. In case method education, this process of years is collapsed into months. The extent to which a student absorbs case lessons depends significantly on how the case study is approached. What can one do to gain the maximum from the study of these cases and the taking of stands?

1. Reading the Case. The very first time you read any case, look for the forest, not the trees. This requires that your first reading be quick. Don't begin taking notes on the first round; instead, read the case like a magazine article. The first few paragraphs of a well-constructed case usually say something about the problem—read those carefully. Then quickly read the rest of the case, seeking mainly a sense of the scope of the problems and what information the case contains to help resolve them. Leaf through the exhibits, looking for what information they hold, rather than for any analytical insights. At the conclusion

¹In the 1990s a statement such as this would surely recognize women as well.

²Speech at the Sorbonne, Paris, April 23, 1910.

³Even deciding not to decide, is to decide, as Napoleon once observed.

of the first reading, read any supporting articles or notes that your instructor may have recommended.

2. Getting into the Case Situation. With the broader perspective in mind, the second and more detailed reading will be more productive. The reason is that as you now encounter details, your mind will be able to organize them in some useful fashion rather than inventorying them randomly. Making linkages among case details is necessary toward solving the case. At this point you can take the notes that will set up your analysis.

The most successful students project themselves into the position of the decision maker because this perspective helps them link case details as well as develop a stand on the case problem. Assignment questions generally will not prompt you to do this, so you have to get into the habit of doing it yourself. Here are the kinds of questions you might try to answer in preparing every case:

- a. Who is the protagonist of the case? Who must take action on the problem? What do they have at stake? What pressures are they under? What do they have to gain (lose) if they succeed (fail)?
- b. In what business is the company? What is the nature of its product? What is the nature of demand for that product? What is the firm's distinctive competence? With whom does it compete?⁴ What is the structure of the industry? Is the firm comparatively strong or weak? In what ways?
- c. What are the goals of the firm? What is the firm's strategy in pursuit of these goals? (The goals and strategy might be explicitly stated, or they may be implicit in the way the firm does business.) What are the firm's apparent functional policies in marketing (e.g., push versus pull strategy), production (e.g., in labor relations, use of new technology, distributed production versus centralized), and finance (e.g., the use of debt financing, payment of dividends)? (Financial and business strategies often can be inferred from analysis of financial ratios and a sources and uses of funds statement.)
- d. How well has the firm performed in pursuit of its goals? (The answer to this question calls for simple analysis using financial ratios, such as the Du Pont system, compound growth rates, and measures of value creation.)⁵

3. Defining the Problem. A common trap for many executives is to assume that the issue at hand is the real problem worthy of their time, rather than a symptom of some larger problem. For instance, a lender is often asked to advance

⁴Think broadly about competitors. Mark Twain wrote in *A Connecticut Yankee in King Arthur's Court*, "The best swordsman in the world doesn't need to fear the second best swordsman in the world; no, the person for him to be afraid of is some ignorant antagonist who has never had a sword in his hand before; he doesn't do the thing he ought to do, and so the expert isn't prepared for him; he does the thing he ought not to do; and often it catches the expert out and ends him on the spot."

⁵Simply put, are the stockholders being compensated for the risk of their investment? Has the stock price performed well, relative to the market?

funds to help tide a firm over a cash shortfall; careful study may reveal that the key problem is not a cash shortfall, but rather it is product obsolescence, unexpected competition, or careless cost management. Even in cases where the decision is fairly narrowly defined (such as in a capital expenditure choice), the “problem” generally turns out to be the believability of certain key assumptions. Students who are new to the case method tend to focus narrowly in defining problems and often overlook the influence which the larger setting has on the problem; in doing this the student develops narrow specialist habits, never achieving the general manager perspective. It is useful and important for you to define the problem yourself and, in the process, validate the problem as suggested by the protagonist in the case.

4. Analysis: Go to the Heart of the Matter. Some cases, reflecting reality, invite you to explore blind alleys. If you are new to finance, even these explorations will help you learn.⁶ The best case students have or develop an instinct for where to devote their analysis. Economy of effort is desirable. If you have invested wisely in problem definition, economical analysis tends to follow. For instance, a student might assume that a particular case is meant to exercise financial forecasting skills and will spend two or more hours preparing a detailed forecast, instead of preparing a simpler forecast in one hour and conducting a sensitivity analysis based on key assumptions in the next hour. An executive rarely thinks of a situation as having to do with a forecasting method or discounting or any other technique, but rather he or she thinks of it as a problem of judgment, deciding on which people or concepts or environmental conditions to bet. The best case analyses always get through to the business issues rather quickly and avoid the lengthy churning through relatively unimportant calculations.

5. Take a Stand. To develop analytical insights without making recommendations is useless to executives and drains the case study experience of some of its learning power. A stand means having a point of view about the problem, a recommendation, and an analysis to back up both of them.

6. In Class: Participate Actively in Support of Your Conclusions, but Be Open to New Insights As They Emerge. Of course, one can have a stand without the world being any wiser. To take a stand in case discussions means to participate actively in the discussion and to advocate your stand until new facts or analysis emerge to warrant a change.⁷ Learning by the case method

⁶Case analysis is often iterative: an understanding of the big issues invites an analysis of details—then the details may restructure the big issues and invite the analysis of other details. In some cases, getting to the “heart of the matter” will mean just such iteration.

⁷One caveat: there is a difference between taking a stand and pigheadedness. Nothing is served by clinging to your stand to the bitter end in the face of better analysis or common sense. Good managers recognize new facts and arguments as they come to light, and adapt.

not a spectator sport. A classic error many students make is to bring into the case method classroom the habits of the lecture hall (i.e., passively absorbing what other people say). These habits fail miserably in the case method classroom, because they only guarantee that one absorbs the truths and fallacies uttered by others. The purpose of case study is to develop and exercise one's *own* skills and judgment. This takes practice and participation, just as in a sport. Here are two good general suggestions: (1) defer significant note-taking until after class and (2) strive to contribute to every case discussion.

CONCLUSION: PROCESS, NOT PRODUCT

View the case method experience as a series of opportunities to test your mastery of techniques and your business judgment. If you seek a list of axioms to be etched in stone, you are bound to disappoint yourself. As in real life, there are virtually no "right" answers in these cases in the sense that a scientific or engineering problem has an exact solution. What matters is that you obtain a way of thinking about business situations that you can carry from one job (or career) to the next. In the case method it is largely true that: how you learn is what you learn.⁸

⁸In describing the work of case teachers, John H. McArthur has said, "How we teach is what we teach."

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