Course Description

This course emphasizes problem solving and applications for the theories of modern finance. What efficiencies of markets means in a practical sense is demonstrated, the economic model of the firm is compared with the accounting model, the weaknesses of the accounting framework are demonstrated in valuation of acquisitions and designing incentive contracts for management. Dividend policy and capital structure are investigated as they relate to changes in share value and the price-to-earnings ratio. The concept of cost of capital is shown to be independent of capital structure even in the real world, a principal component of the Miller-Modigliani theorems in a world of perfect capital markets. Finally, three alternate models are presented for pricing firms, including initial public offerings, acquisitions and divestitures and for internal capital allocation. Strategic planning and valuation is reconciled and the EVA framework is used for designing incentive contracts for management, boards of directors and even for all employees right down to the shop floor. The emphasis is on real world illustrations. The student should have achieved a practical understanding of the theories of modern finance when the course is completed.

Specific Requirements

There are two specific requirements for the course in addition to expected attendance. The first is a paper that will be submitted on a date to be determined by Professor Stern, which will be a valuation of a publicly traded firm. Your task is to compare the value calculated with the actual value, and if there is a significant difference, you are to explain the principal causes. The second requirement is a final examination. Each will account for 50 percent of the final grade. However, the instructor has the option of 10 percentage points based on class participation.
Required Reading

The first three chapters of reading in (1) are required for the first lecture. Required reading (3), the Arzac volume on valuation must be completed during the course, but it is most important that the content of his book be completed by the time we complete session #8 which completes the discussion of valuation as presented by Arzac. The remaining issues on valuation are discussed in session 10 and they are concerned with the EVA model evaluation. This is found in Stewart’s Quest for Value and in reading (5)a.

(2) The EVA Challenge, by Joel M. Stern and John S. Shiely with Irwin Ross; John Wiley & Sons, Inc. 2001;
(3) Valuation for Mergers, Buyouts, and Restructuring, by Enrique R. Arzac; John Wiley & Sons, Inc. 2005;
(5) Journal of Applied Corporate Finance - as assigned:
   (d) “Still Searching for Optimal Capital Structure”, by Stewart C. Myers, 6.1, Spring 1993: 4-14;
   (g) “Capital Structure and Stock Repurchase”, Stern Stewart Roundtable Discussion, Vol.14,1, Spring 2001, 8-41;
   (i) “How Do CFOs Make Capital Budgeting and Capital Structure Decisions?”, by John Graham, Vol. 1; No. 1, Spring 2002
(8) “Economics Focus Taken for a Ride”, The Economist, July 13, 2002
(10) Joel Stern’s FinWeek Articles
(12) “How to Fix Corporate Governance and Executive Compensation”, by Joel M. Stern and James Kinnear
<table>
<thead>
<tr>
<th>Sessions</th>
<th>Subject</th>
<th>Readings in (1) By Chapter</th>
<th>Readings in (4) &amp; (5) By Letter, (6), (7) (8) &amp; (9)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1, 2</td>
<td>The Structure of Markets and the Conflicting Claims of the Accounting and Economic Models of the Firm</td>
<td>1, 2, 3</td>
<td>5(e)</td>
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<tr>
<td>3</td>
<td>Alternate Uses and Calculations of FREE CASH FLOW</td>
<td>8</td>
<td>All of (7)</td>
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<td>4, 5, 6</td>
<td>Valuation: No corporate income tax, no superior returning projects; a world of taxes, still no superior returning projects; a taxable world with superior returning projects The effect of capital structure on share price and on price to earnings ratio</td>
<td>7, 9</td>
<td>All of (4) especially Sections II &amp; III plus 5(b),(c),(d) All of (6)</td>
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<td></td>
<td>See footnote I</td>
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<td>7, 8</td>
<td>Valuation and economics of information: Bond ratings, share buybacks, preferred shares, dividend policy</td>
<td>10, 11</td>
<td>5(f), (g)</td>
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<tr>
<td>9</td>
<td>The methods and motives of corporate restructuring</td>
<td>13, 14</td>
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<td>10</td>
<td>The EVA challenge, the model, incentive signaling, informational asymmetries, the role of stock options</td>
<td>6</td>
<td>5(b), (c), (h)</td>
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<tr>
<td>11</td>
<td>EVA incentives as a way to reconcile capital structure and dividend signals</td>
<td>5(a) &amp; all of reading (2)</td>
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<tr>
<td>12</td>
<td>Alternative approaches to value and incentives: The case of traditional approaches in the real world</td>
<td>To Be Assigned</td>
<td>Same as session 11 &amp; (8) (9) (10) (11) (12)</td>
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(I) The students will be held responsible for the chapter on this subject in *The Quest for Value* by G. Bennett Stewart.

(II) Students should read *The EVA Challenge* before the course begins and definitely before the course is over since it represents specific ways to apply the theory and policy of modern finance.

(III) Required reading (3), the Arzac volume on valuation must be completed during the course, but it is most important that the content of his book be completed by the time we complete session #8 on valuation which completes the discussion of valuation as presented by Arzac. The remaining issues on valuation are discussed in session #10 and they are concerned with the EVA model evaluation. This is found in Stewart’s *The Quest for Value* and in reading 5(a).