



Course Syllabus (Fall Semester)

FNCE 4301: Advanced Issues in Security Valuation --- 3 Credits

Instructor: Christopher Wilkos **Office:** Finance Dept. **Office Hours:** Tuesday 4 to 5pm
& by appointment

Pre-requisites: FNCE 3101 and FNCE 3302

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Course Description: In this course, we study and interpret general business models, and identify the value drivers that create shareholder wealth. We learn to value an investment through assessing a company's ability to produce free cash flow, maintain a consistent return on capital, and reinvest capital effectively over time. We also interpret financial and management practices that can lead to value destruction. Lastly, we evaluate the psychological framework and investment thought process that is useful in the analysis of the physical, intellectual, and emotional factors related to valuing an investment.

Texts:

Graham, B. and Dodd, D. (1940) Security Analysis: The Classic 1940 Edition, McGraw-Hill
Klarman, Seth A. (1991) Margin of Safety: Risk-Averse Value Investing Strategies for the

Thoughtful Investor, Harper Business

Mauboussin & Callahan Business Sustainability & Measuring the Moat

Thorndike, William N. The Outsiders: Eight Unconventional CEOs

Required Cases:

Investment Policy at the Hewlett Foundation (2005) 205126-PDF-ENG

Design Thinking and Innovation at Apple 609066-PDF-ENG

Warren Buffett, 2005 UV0016-PDF-ENG

Mars Incorporated; Wm. Wrigley Jr. Company UV4277-PDF-ENG

Going to the Oracle: Goldman Sachs, September 2008 309069-PDF-ENG

Kmart, Sears, and ESL: How a Hedge Fund Became One of the World's Largest Retailers KEL133-PDF-ENG

Kmart and ESL Investments (B): The Sears Merger 209045-PDF-ENG

Innovation Corrupted: The Rise and Fall of Enron (A) 905048-PDF-ENG

Enron Corp.: May 6, 2001 Sell Recommendation 104075-PDF-ENG

Starbucks Coffee Company in the 21st Century 808019-PDF-ENG

Bankruptcy and Restructuring at Marvel Entertainment Group 298059-PDF-ENG

Pyramid Schemes? - Avon and Herbalife: Avon.com (A) 503016-PDF-ENG

Avon Products China (A) 300053-PDF-ENG

Aubrey McClendon's Special Incentive Compensation at Chesapeake Energy (A) 110047-PDF-ENG

Mount Everest - 1996 303061-PDF-ENG

Saving Disney 905014-PDF-ENG

GE's Two-Decade Transformation: Jack Welch's Leadership 399150-PDF-ENG

Coursepack link: <https://cb.hbsp.harvard.edu/cbmp/access/27631061>

Course Objectives:

- (1) To recognize the factors that influence the success and achievement of a business. (The term "business" refers to the dynamic nature of Finance, Marketing, Operations, Human Resources and Technology; and how these interact to create a business model to maximize shareholder wealth.)

- (2) To become aware of various business models and the approach to diagnosing the drivers that create business value.
- (3) To examine and critique various tools that are used to value an investment.
- (4) To develop proficiency in the analysis, administration, and interpretation of a business and an investment.
- (5) To demonstrate the strong correlation between business and investing skills that are needed to succeed in the business and investment world---using case studies, team discussions, and group presentations.

Topical Outline: Business and Investing Strategy

Course Introduction: First Semester (week 1)

Discussion on Investing and Speculation (week 1)

INVESTMENT VALUATION INTRODUCTION LECTURE

Questions and discussion points:

- What is the definition of investing?
- What is the definition of speculation?
- What are you trying to achieve when you invest?

Week 1 Readings: Introduction/Chapters 4 and 5 of Security Analysis

by Ben Graham and David Dodd

Buffett's Graham & Doddsville article

Discussion on the Stock Market (week 2)

Questions and discussion points:

- How efficient is the stock market?
- Can the stock market be valued? How?
- What variables influence the stock market?
(Discussion on interest rates, GDP, flow of money)
- How does stock market valuation influence investment decisions?
- What influences investment returns? (Risk, Opportunity Costs, Inflation)
- What is the "Margin-of-Safety" concept?
- How important is diversification?
- What is the difference between investing in Common Stocks vs. Fixed-Income Securities?
- What is the magic of compounding returns? (Beating inflation and taxes)
- What is the difference between "valuing a business" vs. "valuing an investment"?

Discussion on Asset Allocation (week 3)

Investment Policy at the Hewlett Foundation (2005)

In early January 2005, Laurance Hoagland Jr., VP and CIO of the William and Flora Hewlett Foundation (HF), and his investment team met to finish their recommendations to the HF Investment Committee for a new asset allocation policy for the foundation's investment portfolio. If the proposal was approved, HF would adopt a new asset allocation policy that included a substantial reduction in the overall exposure of the investment portfolio to domestic public equities and a significant increase in the allocation to absolute return strategies and TIPS. Hoagland and this team also needed to decide on a complementary recommendation to the HF Investment Committee to pledge approximately 5% of the total value of the portfolio to Sirius V, the latest fund at Sirius Investments, which specialized in global distressed real estate investments.

Case Questions:

- **What are the financial issues facing the Hewlett Foundation (HF)? In particular, is HF's newly proposed asset allocation policy adequate to meet the foundation's long-term spending goal**

of sustaining a long-term real (or inflation-adjusted) payout ratio of 5%, while preserving capital in real terms?

- As a member of HF's Investment Committee, would you agree with the proposals to:
 - a. Double to 20% the allocation to absolute return strategies?
 - b. Implement the bondization and equitization overlay program?
 - c. Make the 5% commitment to Sirius V?
- What are your thoughts on diversification through asset allocation?

Review of the Value Line Investment Survey (week 3)

The Complete Guide to Using The Value Line Investment Survey

The In-Depth Guide to Reading a Value Line Research Report; Value Line Sample Page

Discussion on Business (week 4)

WARREN BUFFETT VIDEO

Discussion on Thought Process and Thinking (weeks 4/5)

Charles Munger Lectures *Readings / Assignment: Charles Munger's 1. Academic Economics Lecture; 2. USC Speech; 3. Paper on Mental Models; and 4. Psychology of Human Misjudgment Audio Lecture*

Discussion question:

- In what ways has Mr. Munger's thinking contributed to the success of Warren Buffett and Berkshire Hathaway?

BUSINESS OF THOUGHT LECTURE

Design Thinking and Innovation at Apple (week 5)

This case describes Apple's approach to innovation, management, and design thinking. For several years, Apple has been ranked as the most innovative company in the world, but how it has achieved such success remains mysterious because of the company's obsession with secrecy. This case considers the ingredients of Apple's success and its quest to develop, in the words of CEO Steve Jobs, insanely great products. Focuses on: 1) design thinking; 2) product development strategy and execution; 3) CEO as chief innovator; and 4) bold business experimentation.

Case questions:

- Why has Apple been so successful? What do you attribute it to?
- Is there as systematic "approach" to innovation at Apple? If yes, how would you characterize it? Can it be imitated? If no, why not?
- Imagine that Apple's management is running the last organization that you have worked for. What would that be like? What would change? What obstacles would be encountered?

Evaluation of a Good Business vs. a Difficult Business (week 6)

INVESTMENT VALUATION LECTURE

Studying two businesses over a period of time (Coca-Cola and Ford Motor Company) and discussing the distinct differences that lead to varied valuations and stock price appreciation over time (GROWTH & RETURN ON INVESTED CAPITAL)

Discussion on Valuing an Investment: (weeks 7/8)

Evaluating key variables that determine investment returns over time---
(Earnings Yield, Owner Earnings Yield, Invested Capital Yield, Growth/Yield Power)

Determining Future Selling Price vs. Current Selling Price/Probable returns over time using The Value Line Investment Survey & Company Financial Statements

Readings: Chapters 1 & 2 of Security Analysis by Ben Graham and David Dodd
Chapters 27, 28 and 29 of Security Analysis by Ben Graham and David Dodd
Readings: Chapters 37, 38 and 39 of Security Analysis by Ben Graham and David Dodd

Warren E. Buffett, 2005

On May 24, 2005, Warren Buffett, the chairman and chief executive officer of Berkshire Hathaway Inc., announced that MidAmerican Energy Holdings Company, a subsidiary of Berkshire Hathaway, would acquire the electric utility PacifiCorp. In Buffett's largest deal since 1998, and the 2nd largest of his entire career, MidAmerican would purchase PacifiCorp from its parent, Scottish Power plc, for \$5.1 billion in cash and \$4.3 billion in liabilities and preferred stock. The acquisition of PacifiCorp renewed public interest in its sponsor, Warren Buffett. In many ways, he was an anomaly. What were the key principles that guided Buffett? Could these be broadly applied in the 21st century, or were they unique to Buffett and his time? From an understanding of these principles, analysts hoped to illuminate the acquisition of PacifiCorp. What were Buffett's probable motives in the acquisition? What did Buffett's offer say about his valuation of PacifiCorp, and how would it compare with valuations for other regulated utilities? Would Berkshire's acquisition of PacifiCorp prove to be a success? How would Buffett define success?

Case question:

- **What are the different ways Warren Buffett evaluates an investment in a business?**

Tootsie Roll and Nike: (Part 1)

Case question:

- **In analyzing each company's financial statements and Value Line page, how would you determine the trading range of the stock price in 10 years? What would be your current buy price?**

Union Pacific, Heinz and Micron: (Part 2)

Case question:

- **In analyzing each company's financial statements and Value Line page, how would you determine the trading range of the stock price in 10 years? What would be your current buy price?**

Recipe for Sweet Success? – Mars, Incorporated; Wm. Wrigley Jr. Company

This case evaluates the evolution of Mars and Wrigley, culminating into an eventual merger. We evaluate the necessity of this merger to create global competitive advantage for these two companies. In our case exercise, one-half the class will prepare only the Wrigley case, and the other half will use the Mars case. Mars and Wrigley are considering a merger and are in the process of negotiating a merger agreement. In the process, we review difficult macroeconomic business expectations, and build assumptions around the value creation that Wrigley brings to Mars Inc.

Case questions:

- **What would you consider to be the attributes that make up a good business? What do you think are the attributes of a not-so-good business?**
- **What creates value in a business? What do you think destroys value in a business?**
- **What important attributes do you think would lead to a successful global market opportunity for a combined Mars and Wrigley?**
- **What are the distinctive challenges facing a successful combination between Mars and Wrigley? How can these challenges be addressed in the merger agreement?**
- **In your opinion, why did Mars pursue Wrigley versus another confectionery company like Hershey?**

Investment versus Speculation (week 9)

Going to the Oracle: Goldman Sachs, September 2008

On September 23, 2008, in the midst of an historic crisis in the U.S. financial markets, Warren Buffett's Berkshire Hathaway invested \$5 billion in Goldman Sachs. Goldman CEO, Lloyd Blankfein, said: "We are pleased that given our longstanding relationship, Warren Buffett, arguably the world's most admired and successful investor, has decided to make such a significant investment in Goldman Sachs." He added that the deal "will further bolster our strong capitalization and liquidity position," calling Buffett's decision "a strong validation of our client franchise and future prospects." For his part, Buffett called Goldman "an exceptional institution" with "...an unrivaled global franchise, a proven and deep management team, and the intellectual and financial capital to continue its track record of outperformance." This case provides an opportunity to evaluate Goldman's decision to raise capital, the cost of the firm of Buffett's investment, and the decision by Warren Buffett to make the investment in Goldman Sachs.

Case questions:

- **How do you think Warren Buffett valued Goldman Sachs?**
- **What are your thoughts on Warren Buffett's investment in Goldman: Investment or Speculation? What evidence can you provide to support your thoughts?**

Kmart, Sears, and ESL: How a Hedge Fund Became One of the World's Largest Retailers Kmart and ESL Investments (B): The Sears Merger

Within 18 months of exiting bankruptcy, Kmart's position was sufficiently strong to launch an acquisition of Sears, once the nation's largest retailer and also a core holding of ESL. Looks at a number of compelling issues related to Kmart's bankruptcy, restructuring, and rebirth under the control of ESL, a large hedge fund. Presents some of the key metrics that Eddie Lampert, head of ESL, had available to him as he made two decisions: first, in 2002, to amass a controlling stake in Kmart's defaulted debt during the restructuring; and second, in 2004, to launch a takeover of Sears. The first deal illustrates the decision-making process for a financial buyer, including the downside protection of Kmart's real estate holdings, whereas the second deal represents a traditional strategic acquisition. Illustrates the innovative use of real estate as a "hedge" for ESL in the event that the retail combination does not produce the required financial results. The second part of the case evaluates the Kmart / Sears merger.

Case questions:

- **How do you think Eddie Lampert valued Kmart and Sears?**
- **What are your thoughts on Eddie Lampert's acquisition of Kmart & Sears: Investment or Speculation? What evidence can you provide to support your thoughts?**
- **What has happened to the Kmart & Sears since Eddie Lampert's investment? Why?**

Discussion on Accounting "Red Flags" (week 10/11)

Innovation Corrupted: The Rise and Fall of Enron (A) Enron Corp.: May 6, 2001 Sell Recommendation

These cases presents a brief historical overview of Enron's rise, its strategic successes and failures, the evolution of its business model, and the organizational processes relied upon by Enron's management to drive and monitor the business. A consulting firm to institutional investors recommends selling Enron Corp.'s equity short on May 6, 2001, while many sellside analysts are recommending the stock as a "buy."

Case questions:

- **What are your thoughts on Enron's business model?**
- **What is the basis for the Off Wall Street "sell" recommendation?**
- **What specifically caused Enron to unravel?**
- **As a potential financial analyst, what lessons can you learn from the Off Wall Street report?**
- **Describe corporations that practiced similar accounting methods as Enron, and the ultimate impact on the company?**

**Starbucks Coffee Company in the 21st Century
Green Mountain Coffee Case: Financial Management**

The case explores the opportunities and challenges confronting Starbucks in the early 21st century. For more than 15 years, Starbucks has grown swiftly and successfully, helping create a large, dynamic market for specialty coffee, building one of the world's most powerful brands, and forging a new business model based on industry disrepair and responsible global citizenship. In 2008, Starbucks leadership faces a range of issues--inside and out of the company--related to that success. This case examines these issues in the context of a changing economy, increased competition, evolving consumer priorities, and the organization's place on the larger global stage.

Case questions:

- **What attributes make Green Mountain Coffee a good investment?**
- **What are your thoughts regarding the accounting red flags?**
- **What impact do you think Green Mountain Coffee can have on Starbucks?**
- **If you were Howard Schultz / Starbucks – What would you do?**

Discussion on Corporate Governance (week 11/12)

Bankruptcy and Restructuring at Marvel Entertainment Group

Marvel Entertainment Group is the leading comic book publisher in the United States, with superheros like Spider-Man, the Incredible Hulk, the X-Men, and Captain America. It is also one of the leading manufacturers of sports and entertainment trading cards under the Fleer and Sky Box brand names. In the mid-1990s, it experienced sharp declines in both businesses, causing it to file for bankruptcy in December 1996. This case is set in late January 1997, shortly after Marvel filed its reorganization plan with the bankruptcy court and approximately one month before creditors will have to vote on the plan at the confirmation hearing. Two of the most prominent corporate raiders of the 1980s are pitted against each other for control of the company. On one side is Ronald Perelman, who controls Marvel through his MacAndrews & Forbes holding company. On the other side is Carl Icahn, who controls 25% of Marvel's public debt. Icahn and the other bondholders must decide whether to accept Perelman's plan, to reject it in favor of their own plan, or to sell their bonds before the confirmation hearing.

Case questions:

- **Why did Marvel file for Chapter 11? Were the problems caused by bad luck, bad strategy, or bad execution?**
- **What are your thoughts on the proposed restructuring plan? Will it solve the problems that caused Marvel to file Chapter 11? As Carl Icahn, the largest unsecured debtholder, would you vote for the proposed restructuring plan? Why or why not?**
- **Will it be difficult for Marvel or other companies in the MacAndrews and Forbes holding company to issue debt in the future?**
- **What do you think of Ron Perelman's business practices and shareholder orientation?**
- **How effective are organizations like MacAndrews & Forbes and Icahn Enterprises within a capitalist society?**

Pyramid Schemes? – Avon and Herbalife: Avon.com (A) & Avon Products China (A)

Avon has always sold its products through a large independent direct-selling organization. However, it is now considering whether it should sell directly to the consumer. The company's independent representatives number 500,000 in the United States alone, with expansion in China in the early stages. There seems to be potential for Avon to grow their business on the web, and throughout emerging economies in new and different ways. However, multi-level marketing companies have a reputation for building distribution schemes, and emphasize growing sales by adding distributors versus developing sales to consumers.

Herbalife International is a multi-level marketing company (like Avon) that sells nutrition, weight management and skin-care products. The company was founded in 1980, and it employs around 7,400 people worldwide. Activist investor Bill Ackman has a \$1.0 billion short position on Herbalife, stating that it is an extreme pyramid scheme. Carl Icahn, another activist investor has taken an opposite investment position, going long on Herbalife, stating that it is a legitimate business. In this case, the first half of the class will be instructed by Bill Ackman, who thinks the multi-level marketing businesses are pyramid schemes – especially Herbalife. The second part of the class will be instructed by Carl Icahn, who believes that these companies represent legitimate businesses.

Case questions:

- **What are your thoughts on multi-level marketing companies such as Avon, Pampered Chef, and Herbalife – are they pyramid schemes or legitimate businesses? Why?**
- **What long-term opportunities exist in emerging markets for Avon and Herbalife – which company has a better long-term global opportunity? Why?**
- **What role does the direct consumer channel have in these companies with the advent of the Internet? How will appealing direct to the consumer impact the distribution network?**
- **If you were Mr. Ackman, how would you have “tested” the pyramid scheme nature of Herbalife’s business model? Why has he not done this?**
- **If you were Carl Icahn, what concerns would you have with Herbalife’s long-term business model? How would you alleviate your concerns?**

Aubrey McClendon's Special Incentive Compensation at Chesapeake Energy (A)

Aubrey McClendon, founder and CEO of Chesapeake Energy, was, according to Fortune Magazine, the highest paid U.S. CEO in 2008 receiving over \$100 million in total compensation. McClendon received this compensation despite a significant drop in the company's stock price and financial performance during the year. The (A) case addresses the specifics of the compensation and the rationale for the compensation from the perspective of Chesapeake's board and its compensation committee including McClendon's role in consummating several joint ventures, which the board and committee believed positioned the company for future growth in the relatively young industry of unconventional natural gas exploration and extraction. In addition, the (A) case describes the role of the compensation committee and the company's executive performance measurement factors.

Case questions:

- **What are your thoughts regarding Aubrey McClendon’s compensation package?**
- **Are there any other areas of Chesapeake Energy’s governance practices that cause you concern?**
- **What similarities / differences do you see between Enron and Chesapeake Energy?**
- **What would you do if you were a large owner of Chesapeake Energy stock?**

Discussion on Corporate Management & Leadership (weeks 12/13)

Mount Everest--1996

In May 1996 Rob Hall and Scott Fischer, two of the world’s most accomplished mountaineers, each led an expedition attempting to reach the top of Mount Everest. Five individuals, including the two leaders, died during the descent from the summit on May 11. It proved to be the deadliest day in the mountain’s history. Since then, many survivors and other observers have tried to explain why this tragedy occurred. Drawing from various first-hand accounts of the tragedy, the case provides a detailed account of the key events that took place in the days leading up to and including the final summit bid. The case describes how Fischer and Hall organized and led these two teams, and it documents the critical decisions that the leaders and their clients made during the climb.

Case questions:

- **Why did this tragedy occur? What is the root cause of this disaster?**
- **Are tragedies such as this simply inevitable in a place like Everest?**
- **What is your evaluation of Scott Fischer and Rob Hall as leaders? Did they make poor decisions? If so, why?**
- **What are the lessons from this case for general managers in business enterprises?**

Saving Disney

At a March 2004 annual shareholder meeting, 45% of Walt Disney Co.'s shareholders withheld their support from CEO and Chairman Michael Eisner, producing a large no-confidence vote in the company's leader. The company had struggled financially in recent years and the board was widely believed to be beholden to Eisner. Two directors, Roy Disney and Stan Gold, resigned in protest of Eisner's leadership and the board's unwillingness to change. The two began to wage a PR battle calling for Eisner's removal and asking all shareholders to withhold their support from him at the upcoming shareholder meeting.

Case questions:

- Why has Disney been successful over the decades?
- How would you describe Michael Eisner as a leader?
- What are your thoughts regarding Michael Eisner's management of Disney?
- What did Michael Eisner originally do to rejuvenate Disney? What happened?
- What would you suggest that Michael Eisner change to overcome his leadership problems?

GE's Two-Decade Transformation: Jack Welch's Leadership (HBS Multimedia Case)

GE is faced with Jack Welch's impending retirement and whether anyone can sustain the blistering pace of change and growth characteristic of the Welch era. After briefly describing GE's heritage and Welch's transformation of the company's business portfolio of the 1980s, the case chronicles Welch's revitalization initiatives through the late 1980s and 1990s. It focuses on six of Welch's major change programs: The "Software" Initiatives, Globalization, Redefining Leadership, Stretch Objectives, Service Business Development, and Six Sigma Quality.

Case questions:

- What are your thoughts regarding Jack Welch's leadership?
- What are your thoughts regarding Jack Welch's management style?
- How effective was Jack Welch in creating long-term value at GE?

"Your Road to Success" – Speech

GRADING:

Class Participation/Case Preparation	80%
*Analyst report/SMF Fund:	5%
Final Exam	15%

Class Participation & Case Summaries

Class Participation & Case Summaries will involve your ability to isolate and interpret key case factors, and reach conclusions regarding the case to be reviewed in class. Prior to the class discussion on each case, you will be asked to hand in your "two-page (single space)" summary/conclusions, along with the assigned case. Each written summary will count toward 2.5% of the final grade, along with class participation in each case of 2.5%, for a total 80% possibility of the class grade generated between written summaries and participation.

***NON-SMF Student Project:**

You have \$100,000 to invest in equities, and can invest in 7 to 10 companies (in equal amounts) at an investment of \$10,000 to \$15,000 per security. You can pick any industries that you desire to develop a diversified portfolio (No margin, short selling etc.). Once you decide to make an investment(s) you can e-mail me the company(ies) that you are purchasing, and the closing price of the company(ies) for that day, along with the number of shares you are buying.

During the semester you can also trade any of the investments in your portfolio. If a position has a substantial gain (or loss), and you want to purchase another company, you can do that at any time....just e-mail me the company that you are selling/purchasing, and the closing price of each company for that day, along with the number of shares you are selling/buying.

At end of each month (September, October, November), you will provide a total listing of your investments, along with the return of your portfolio that month vs. the return (or loss) against the S&P 500 index. Along with the portfolio listing, you will provide a short explanation (no more than two paragraphs) of why you think your portfolio performed better or worse than the S&P 500 index. (The monthly paper will be due the first class after the end of the previous month.)



Final Exam

The final exam will be a case study that will be completed within the allotted final exam timeframe. You will be required to provide a complete in-depth analysis of the case, and answer the case questions with a breakdown of your personal thoughts and perspective.