

Economics 314S
Finance

Dr. David Martin
Spring 2006

Meetings: 9:30-10:20 MWF in Chambers 1086
Office Hours: 10:30-12:00 MWF, 2-3 TTh, and other times by appointment
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The purpose of this course is to examine some fundamental aspects of financial theory (net present value, option pricing, the capital asset pricing model, market efficiency, capital structure, risk management, agency theory, and mergers) through economic theory and application. I treat this course as a senior-level seminar with an emphasis on class discussion and group analysis, and I expect you to be prepared to contribute to our learning every day.

Prerequisites: Economics 105 (Statistics), Economics 202 (Intermediate Microeconomic Theory), and Economics 211 (Introduction to Accounting). You will use *Excel* extensively and prepare *PowerPoint* presentations regularly.

Grading

Homework	25%	Case Studies 1-5	25%
Discussions	40%	Preparation	50%
Preparation	50%	Presentation	25%
Leading	25%	Participation	25%
Participation	25%	Case Study 6	10%

Homework: The purposes of these problems are to reinforce the concepts developed by Brealey, Myers, and Allen and to give you practice using those tools. You (and at most two other students of your choice) will work the problems and grade your work according to the scale below.

- 3.....I worked the problem by the due date and give myself full credit for understanding it.
- 2.....I worked the problem by the due date and give myself partial credit for understanding it.
- 1.....I completed the problem no later than 1 class meeting after the due date.
- 0.....Anything else.

Discussions: You will prepare discussions in groups of two or three that I assign, and each group will work independently of the other groups. A typical discussion preparation might involve a two-page paper and a supporting spreadsheet analysis. The discussion leaders will likely use *PowerPoint* to make their initial points.

Case Studies 1-5: You will work these independently. Two or three students will present their decisions with *PowerPoint* before the floor opens for the class to reach a consensus.

Case Study 6: One set of groups will represent *Hybritech* and the other set *Eli Lilly*. Your firm's mission will be to conduct merger negotiations with (against?) the other firm.

Attendance: If you are absent for four or more meetings of this class for any reason, then you will earn a grade of F for the course regardless of other work done for it. Please note that the meetings on Sunday, April 23 (1-4 pm), and Friday, May 5 (9-11 am), will count as three absences each.

Network File Space: The network folder *P:\Economics\Eco 314 (Finance)* has three subfolders.

- *P:\Economics\Eco 314 (Finance)\Collaborative Work Area:* The purpose of this folder is to enhance your capability to work collaboratively as you will have security rights that will allow you to work here. You are honor-bound to access only your group's materials. I will periodically clean old materials from this folder.
- *P:\Economics\Eco 314 (Finance)\Completed Assignments:* You will turn in your completed spreadsheets and presentation materials into this folder's subfolders (you won't have sufficient security rights to work in this folder). Again, you are honor-bound to access only your group's materials.
- *P:\Economics\Eco 314 (Finance)\Readings and Materials:* I will place reading materials, some spreadsheets, and other materials in here for your use. While you may use the spreadsheets as the starting point for your work and you may view and print these materials, you are honor-bound not to copy, save, or distribute these files in any way. If you do so then you will earn a grade of F for the course regardless of other work done for it.

The Honor Code is a critical component of life at Davidson. Let's keep it that way!

Reading Materials

I've listed the readings in the order that they appear in the syllabus. *Principles of Corporate Finance, Eighth Edition* can be purchased at the bookstore. The other readings* will be available at a cost that reflects the copyright permissions; in 2004, the copyright permissions cost \$43.

- BMA*Brealey, Richard A., Stewart C. Myers, and Franklin Allen 2006. *Principles of Corporate Finance, Eighth Edition*. New York: McGraw-Hill.
- Radio One*Fisher, Pauline, and Richard S. Ruback. May 2001. *Radio One, Inc.* Harvard Business School. 9-201-025.
- Butterflies/Condors**The Economist*. Of Butterflies and Condors. February 16, 1991. 58-59.
- Citic Tower*Ho, Mary, and Frederik Pretorius, Frederik. July 16, 2002. *CITIC Tower II: The Real Option*. Centre for Asian Business Cases, School Business, The University of Hong Kong.
- Arundel Sequels*Luehrman, Timothy A., and William A. Teichner. June 1992. *Arundel Partners: The Sequel Project*. Harvard Business School. 9-292-140.
- Cornell*Cornell, Bradford. Spring 2001. Is the Response of Analysts to Information Consistent with Fundamental Valuation? The Case of Intel. *Financial Management*. **30**(1):113-136.
- RJR Nabisco (2)*Dammon, Robert M., Kenneth B. Dunn, and Chester S. Spatt. December 1993. The Relative Pricing of High-Yield Debt: The Case of RJR Nabisco Holdings Capital Corporation. *The American Economic Review*. **83**(3):1090-1111. Downloaded from JSTOR.
-Tufano, Peter. June 1995. *RJR Nabisco Holding Capital Corporation – 1991*. Harvard Business School. 9-292-129.
- Ameritrade CoC*Mitchell, Mark L., and Erik Stafford. 2001. *Cost of Capital at Ameritrade*. Harvard Business School. 9-201-046.

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- Eskimo Pie*Ruback, Richard S. December 2003. *Eskimo Pie Corporation (Abridged)*. Harvard Business School. 9-202-037.
- ServerVault*Bruner, Robert F., and J. Chadwick Rynbrandt. 2000. *ServerVault: Reliable, Secure, and Wicked Fast*. Darden Graduate School of Business. UVA-F-1304.
- Marriott CoC*Ruback, Richard S. April 1, 1998. *Marriott Corporation: The Cost of Capital (Abridged)*. Harvard Business School. 9-289-047.
- MCI Capital Structure*Chaplinsky, Susan, and Robert S. Harris. March 31, 1997. *MCI Communications Corp.: Capital Structure Theory*. UVA-F-1175.
- Honeywell*Barnett, Jonathan, and Lisa Meulbrook. July 2000. *Honeywell, Inc. and Integrated Risk Management*. Harvard Business School. 9-200-036.
- Interest Derivatives*Headley, Jonathan S., and Peter Tufano. June 28, 1995. *Interest Rate Derivatives*. Harvard Business School. 9-294-095.
- J&L Railroad*Lehman, Jeannie. 1994. *J&L Railroad*. Darden Graduate Business School. UVA-F-1053.
- Yale University*Lerner, Josh. March 5, 2004. *Yale University Investments Office: June 3003*. Harvard Business School. 9-204-055.
- Enron*Bhatnagar, Sanjay, and Peter Tufano. September 1995. *Enron Gas Services*. Harvard Business School. 9-294-076.
- DeLong*DeLong, Gayle L. Summer 2003. Does Long-Term Performance of Mergers Match Market Expectations? Evidence from the U.S. Banking Industry. *Financial Management*. **32**(2):5-25.
- Barbarians (4)*.....Ticer, Scott. December 5, 1988. RJR Tobacco: More Smoke than Fire. *Business Week*. 27. Full text file retrieved 28 December 2005 from *Lexis/Nexis Academic*. Davidson College.
-Greenwald, John, Richard Hornick, William McWhirter, and Frederick Ungeheuer. December 5, 1988. Where's the Limit? The biggest takeover battle in history raises questions about greed, debt and the well-being of American industry. *Time*. 66-70. Full text file retrieved 28 December 2005 from *InfoTrac OneFile*. Thomson Gale. Davidson College.
-Greenwald, John, Raji Samghabadi, and Frederick Ungeheuer. December 12, 1988. \$25,000,000,000: buyout barons KKR outfox Ross Johnson's group and walk off with RJR Nabisco, but the price comes with a colossal debt load. *Time*. 56-57. Full text file retrieved 28 December 2005 from *InfoTrac OneFile*. Thomson Gale. Davidson College.
-HBO Studios. *Barbarians at the Gate* (starring James Garner, et al.). Theatrical Release 1992. Rated R.
- Ben & Jerry*Schill, Michael J. 2001 (Revised 10/2003). *Ben & Jerry's Homemade*. Darden Graduate Business School. UVA-F-1364.
- Hope Enterprises*Harris, Robert S. June 24, 1998. *Hope Enterprises*. Darden Graduate Business School. UVA-F-1219.

The following readings will be distributed in class as part of **Case Study 6**.

- Bruner, Robert F., and Casey S. Opitz. September 1990. *Hybritech Incorporated (A)*. Darden Graduate Business School. UVA-F-0792.
- Bruner, Robert F., and Casey S. Opitz. September 1990. *Eli Lilly and Company*. Darden Graduate Business School. UVA-F-0794.
- Bruner, Robert F., and Casey S. Opitz. July 1989. *Hybritech Incorporated (B)*. Darden Graduate Business School. UVA-F-0793.

Daily Schedule

<u>Day</u>	<u>Date</u>	<u>Topic</u>	<u>By next class</u>
1	M 1/9	Introduction to the course Lecture: Fisher Separation Theorem	Read <i>BMA</i> 1, 35
Net Present Value Theory			
2	W 1/11	Lecture: Basic Present Value	Read/HW <i>BMA</i> 2, 5.1-5.3
3	F 1/13	Lecture: Applying NPV	Read/HW <i>BMA</i> 3, 4 Prepare Discussion 1
4	W 1/18	Discussion 1: Minicase from <i>BMA</i> 5 Lecture: Investment using NPV	Read/HW <i>BMA</i> 6
5	F 1/20	Lecture: NPV and Sensitivity Analysis, Decision Trees, and Strategy	Read/HW <i>BMA</i> 10.1, 10.3, 11
6	M 1/23	Lecture: When is NPV positive?	Prepare Discussions 2 and 3
7	W 1/25	Discussion 2: Minicase from <i>BMA</i> 4 Discussion 3: Minicase from <i>BMA</i> 6	Prepare Discussions 4 and 5
8	F 1/27	Discussion 4: Minicase from <i>BMA</i> 10 Discussion 5: Minicase from <i>BMA</i> 11	Prepare Case Study 1
9	M 1/30	Case Study 1: <i>Radio One</i> case study	Read <i>Butterflies/Condors</i>
Option Pricing			
10	W 2/1	Lecture: Introduction to Options	Read/HW <i>BMA</i> 20
11	F 2/3	Lecture: Binomial Option Valuation	Read/HW <i>BMA</i> 21.1-2, 22.2-3
12	M 2/6	Lecture: Black-Scholes Option Valuation	Read/HW <i>BMA</i> 21.3-5, 22.1, 22.4-5
13	W 2/8	Lecture: Continuing with Real Options	Prepare Discussion 6
14	F 2/10 [†]	Discussion 6: Minicase from <i>BMA</i> 21	Prepare Discussion 7
15	M 2/13 [‡]	Discussion 7: <i>Citic Tower</i> case study	Read/HW <i>BMA</i> 7.1-3
17	F 2/17	Case Study 2: <i>Arundel Sequels</i> case study	Read/HW <i>BMA</i> 7.4-5, 8.1

[†] Economics 495: Oral exams: February 9-12

[‡] Economics 495: ETS Major Field Test

The Capital Asset Pricing Model (CAPM) and Efficient Markets

<u>Day</u>	<u>Date</u>	<u>Topic</u>	<u>By next class</u>
16	W 2/15 [§]	Lecture: Risk and Return	Prepare Case Study 2
18	M 2/20 ^{**}	Lecture: Introduction to the CAPM	Read/HW <i>BMA</i> 8.2-3
19	W 2/22	Lecture: Using the CAPM	Read/HW <i>BMA</i> 9 Prepare Discussion 8
20	F 2/24	Discussion 8: Minicase from <i>BMA</i> 9 Lecture: Introduction to the Market Efficiency	
Spring Break			
21	M 3/6	Lecture: Capital Market Efficiency	Read/HW <i>BMA</i> 13, 8.4 Prepare Discussions 9 and 10
22	W 3/8	Discussion 9: <i>Cornell</i> Discussion 10: <i>RJR Nabisco</i> (2)	Prepare Discussion 11
23	F 3/10	Discussion 11: <i>Ameritrade CoC</i> case study	Prepare Case Study 3
24	M 3/13	Case Study 3: <i>Eskimo Pie</i> case study	Read <i>BMA</i> 14, 15

A Firm's Capital Structure

25	W 3/15	Lecture: The Payout Controversy (MM III)	Read/HW <i>BMA</i> 14.1, 16
26	F 3/17	Lecture: What is debt?	Prepare Discussion 12
27	M 3/20	Discussion 12: <i>ServerVault</i> case study	Read/HW <i>BMA</i> 14.3, 23.1-3, 25
28	W 3/22	Lecture: Debt versus Equity (MM I & II)	Read/HW <i>BMA</i> 17 Prepare Discussion 13
29	F 3/24	Discussion 13: Minicase from <i>BMA</i> 25	Read/HW <i>BMA</i> 18
30	M 3/27	Lecture: Financing and Valuation 1	Read/HW <i>BMA</i> 19
31	W 3/29	Lecture: Financing and Valuation 2	Prepare Discussion 14
32	F 3/31	Discussion 14: <i>Marriott CoC</i> case study	Prepare Case Study 4
33	M 4/3	Case Study 4: <i>MCI Capital Structure</i> case	Read/HW <i>Honeywell</i>

[§] Economics 495: Departmental Microeconomics Exam

^{**} Economics 495: Departmental Macroeconomics Exam

Risk Management

<u>Day</u>	<u>Date</u>	<u>Topic</u>	<u>By next class</u>
34	W 4/5	Lecture: Risk Management 1	Read/HW <i>BMA 27</i> and <i>Interest Derivatives</i>
Meet with Alex Porter ('60, DC Trustee, Founder and President of Porter Orlin LLC) on April 6 or 7.			
35	F 4/7	Lecture: Risk Management 2	Prepare Discussion 15
36	M 4/10	Discussion 15: <i>J&L Railroad</i> case study	Prepare Discussion 16
37	W 4/12	Discussion 16: <i>Yale University</i> case study	Prepare Case Study 5
38	F 4/14 ^{††}	Case Study 5: <i>Enron</i> case study	Read <i>BMA 1.4, 2.3</i> , and <i>DeLong</i>
	M 4/17	Easter Break	

Agency Theory and Corporate Restructuring

39	W 4/19	Lecture: Agency	Read/HW <i>BMA 12</i>
40	F 4/21	Lecture: Mergers	Read/HW <i>BMA 32</i> Prepare Discussion 17
41	Sunday 4/23, 1-4 pm	Discussion 17: <i>Barbarians (4)</i>	
42	M 4/24	Lecture: Corporate Restructuring	Read/HW <i>BMA 33</i> Prepare Discussion 18
43	W 4/26 ^{‡‡}	Discussion 18: <i>Ben & Jerry</i> case study	Prepare Discussion 19
44	F 4/28	Discussion 19: <i>Hope Enterprises</i> case study	Reread <i>BMA 35</i>
45	M 5/1	Lecture: Lessons Learned Distribute Case Study 6 materials	Read <i>Hybritech (A)</i> or <i>Lilly</i> Each group map out strategy
	W 5/3	No class – meet with each group	Finalize negotiation strategy Conduct merger negotiations Read <i>Hybritech (B)</i>
In lieu of a final exam: Friday, May 5, 9-11 a.m., Alvarez 313			Case Study 6

^{††} Economics 495: Group Projects due

^{‡‡} If possible, we'll move this meeting to accommodate *Free Cone Day* at Ben & Jerry's.