

FIN 394.2

MW 8:00 a.m. – 9:30 a.m. (03435)

MW 9:30 a.m. – 11:00 a.m. (03440)

MW 11:00 a.m. – 12:30 p.m. (03445)

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Fall 2010

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Office hours:

Mon. 12:30 p.m. – 1:30 p.m.

and by appointment

Financial Strategies In Private Equity

Course Objectives

This course examines the application of advanced corporate finance concepts in the private equity markets. Private equity is a major source of capital for new and established private and public firms. The size of the organized private equity market has grown dramatically since the early 1990s. For example, capital committed to traditional private equity funds in the U.S. increased from \$8 billion in 1991 to over \$250 billion in 2007. During the last decade hedge funds have also become major investors in private equity. Even with the much-publicized decline in private equity investment activity after 2007, commitments to private equity investments during 2008 and 2009 greatly exceeded the funds committed annually during the famous hostile takeover era of the 1980s. The amount of capital that has been committed to traditional private equity funds worldwide, but remains un-invested as of mid-2010, is estimated to be over \$750 billion.

The objectives of this course are to provide students with an understanding of the nature of the private equity markets, the principal participants in these markets and their activities, and the financial strategies that they employ. Topics covered include: How private equity funds are raised, structured, and financed; contracting in the private equity markets; financing investments; valuation of business interests; corporate restructuring and reorganization; M&A, and exit strategies.

Prerequisites for this course are BA 285T, FIN 286, FIN 397.1, and FIN 394.1.

Course Packet and Useful References

The course packet, which is available at the University COOP, contains daily assignments, readings, and the cases that will be discussed during the course. **The course packet is the only required text.** However, you may find the following books to be useful references at various times during the course.

General references:

Berk, Jonathan and Peter DeMarzo, 2007, Corporate Finance, Pearson/Addison-Wesley, Boston, MA.

Private equity references:

Bartlett, Joseph W., 1995 & 2009, Equity Finance: Venture Capital, Buyouts, Restructurings, and Reorganizations (2nd ed., 2009 Cumulative Supplement), Aspen Publishers division of Wolters Kluwer Law & Business, New York, NY.

Levin, Jack S., 2009, Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions, Aspen Publishers division of Wolters Kluwer Law & Business, New York, NY.

Metrick, Andrew, 2007, Venture Capital and the Finance of Innovation, John Wiley & Sons, Inc., Hoboken, NJ.

Schell, James M., 1999, Private Equity Funds: Business Structure and Operations, Law Journal Press, New York, NY.

Valuation and mergers and acquisitions references:

Koller, Tim, Marc Goedhart, and David Wessels, 2010, McKinsey Valuation (5th ed.), John Wiley & Sons, Inc., Hoboken, NJ.

Bruner, Robert F., 2002, Applied Mergers and Acquisitions, John Wiley & Sons, Inc., Hoboken, NJ.

Gaughan, Patrick A., 2006, Mergers, Acquisitions, and Corporate Restructurings (4th ed.), John Wiley & Sons, Inc., Hoboken, NJ.

Course-related information, including the syllabus and handouts, will be posted on Blackboard.

Course Requirements and Grading

Final grades will be determined as follows:

Weight

Midterm Exam

20%

There will be an in-class exam on October 13, 2010. Students will be responsible for all course material covered up through October 11, 2010.

Final case

40%

The final assignment in this course will consist of a written case analysis (individually prepared). The case will be distributed on the last day of class, December 1, 2010, and the analysis will be due by 9:00 a.m. on Wednesday, December 8, 2010. The report will not exceed six pages (including exhibits). See page 9 of this syllabus for additional details.

Class participation

35%

This portion of the grade will be based on the contribution of each individual student to the class discussion throughout the term. It will be based on the quality and quantity of class participation. Quality will be the far more important of the two dimensions. While each comment will be judged on its merits, worrying about each comment is counterproductive. What is important is your overall contribution to moving the class forward during the semester. Relatively frequent contributions to the discussion that demonstrate logical and thorough analysis will be required to earn 35%.

Peer evaluation

5%

At the end of the semester, I will ask each member of the class to evaluate the contribution of other class members to the quality of the class discussion throughout the semester.

Plus/minus grades will be assigned for the final course grades.

McCombs Classroom Professionalism Policy

The highest professional standards are expected of all members of the McCombs community. The collective class reputation and the value of the Texas MBA experience hinges on this. Faculty are expected to be professional and prepared to deliver value for each and every class session. Students are expected to be professional in all respects.

The Texas MBA classroom experience is enhanced when:

- **Students arrive on time.** On time arrival ensures that classes are able to start and finish at the scheduled time. On time arrival shows respect for both fellow students and faculty and it enhances learning by reducing avoidable distractions.
- **Students display their name cards.** This permits fellow students and faculty to learn names, enhancing opportunities for community building and evaluation of in-class contributions.
- **Students minimize unscheduled personal breaks.** The learning environment improves when disruptions are limited.
- **Students are fully prepared for each class.** Much of the learning in the Texas MBA program takes place during classroom discussions. When students are not prepared they cannot contribute to the overall learning process. This affects not only the individual, but their peers who count on them, as well.
- **Students attend the class section to which they are registered.** Learning is enhanced when class sizes are optimized. Limits are set to ensure a quality experience. When section hopping takes place some classes become too large and it becomes difficult to contribute. When they are too small, the breadth of experience and opinion suffers.
- **Students respect the views and opinions of their colleagues.** Disagreement and debate are encouraged. Intolerance for the views of others is unacceptable.
- **Laptops are closed and put away.** When students are surfing the web, responding to e-mail, instant messaging each other, and otherwise not devoting their full attention to the topic at hand they are doing themselves and their peers a major disservice. Those around them face additional distraction. Fellow students cannot benefit from the insights of the students who are not engaged. Faculty office hours are spent going over class material with students who chose not to pay attention, rather than truly adding value by helping students who want a better understanding of the material or want to explore the issues in more depth. Students with real needs may not be able to obtain adequate help if faculty time is spent repeating what was said in class. There are often cases where learning is enhanced by the use of laptops in class. Faculty will let you know when it is appropriate to use them. In such cases, professional behavior is exhibited when misuse does not take place.
- **Phones and wireless devices are turned off.** We've all heard the annoying ringing in the middle of a meeting. Not only is it not professional, it cuts off the flow of discussion when the search for the offender begins. When a true need to communicate with someone outside of class exists (e.g., for some medical need) please inform the professor prior to class. Remember, you are competing for the best faculty McCombs has to offer. Your professionalism and activity in class contributes to your success in attracting the best faculty to this program.

Academic Dishonesty

I have no tolerance for acts of academic dishonesty. Such acts damage the reputation of the school and the degree and demean the honest efforts of the majority of students. The minimum penalty for an act of academic dishonesty will be a zero for that assignment or exam.

The responsibilities for both students and faculty with regard to the Honor System are described on <http://mba.mcombs.utexas.edu/students/academics/honor/index.asp>. As the instructor for this course, I agree to observe all the faculty responsibilities described therein. During Orientation, you signed the Honor Code Pledge. In doing so, you agreed to observe all of the student responsibilities of the Honor Code.

If the application of the Honor System to this class and its assignments is unclear in any way, it is your responsibility to ask me for clarification.

Students with Disabilities

Upon request, the University of Texas at Austin provides appropriate academic accommodations for qualified students with disabilities. Services for Students with Disabilities (SSD) is housed in the Office of the Dean of Students, located on the fourth floor of the Student Services Building. Information on how to register, downloadable forms, including guidelines for documentation, accommodation request letters, and releases of information are available online at <http://deanofstudents.utexas.edu/ssd/index.php>. Please do not hesitate to contact SSD at (512) 471-6259, VP: (512) 232-2937 or via e-mail if you have any questions.

Class Schedule/Readings

I. Introduction

- Aug. 25 Lecture 1: Course introduction and overview
 Readings:
 How Firms Raise Capital, Chapter 15 in Fundamentals of Corporate Finance by Robert Parrino and David S. Kidwell, John Wiley & Sons, Inc., Hoboken, NJ, 2009.
 Technical Note: The Private Equity Industry
- 30 Lecture 2: Private equity markets
 Readings:
 Prowse, Stephen D., The Economics of the Private Equity Market, *Economic Review*, Federal Reserve Bank of Dallas (Third Quarter 1998), pp. 21 – 34.
 Acharya, Viral V., Julian Franks, and Henri Servaes, Private Equity: Boom or Bust, *Journal of Applied Corporate Finance* (Fall 2007), pp. 44 – 53.
 Kaplan, Steven N., Private Equity: Past, Present, and Future, *Journal of Applied Corporate Finance* (Summer 2007), pp. 8 – 16.
 Kaplan, Steven N. and Josh Lerner, It Ain't Broke: The Past, Present, and Future of Venture Capital, *Journal of Applied Corporate Finance* (Spring 2010), pp. 36 – 47.

II. How private equity funds are raised, structured, and managed

- Sept. 1 Lecture 3: How private equity funds are raised, structured, and managed
 Readings:
 An Introduction to Private Equity Funds, Chapter 1 in Private Equity Funds: Business Structure and Operations by James M. Schell, Law Journal Press, New York, NY, 1999.
 Structuring Formation of Private Equity Fund, Chapter 10 in Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions by Jack S. Levin, pp 10-1 to 10-62, Aspen Publishers division of Wolters Kluwer Law & Business, New York, NY, 2009.
- 8 Case 1: Yale University Investments Office: August 2006 (investing in private equity)
- 13 Case 2: Acme Investment Trust (analyzing an investment in a private equity fund)

III. Relationships between private equity funds and entrepreneurs/managers

- 15 Lecture 4: Relationships between private equity funds and entrepreneurs
 Readings:
 Term Sheet: The Substance of The Deal Between the Founder and Investors, Chapter 9 in Equity Finance: Venture Capital, Buyouts, Restructurings, and Reorganizations (2nd ed.) by Joseph W. Bartlett (pp 187-210) and pp 73-93 from 2009 Cumulative Supplement, Aspen Publishers division of Wolters Kluwer Law & Business, New York, NY, 1995 & 2009.

Form 26-1: Sample Term Sheet, in Volume 3 of Equity Finance: Venture Capital, Buyouts, Restructurings, and Reorganizations (2nd ed.) by Joseph W. Bartlett (pp 86-98) and 557-562 from 2009 Cumulative Supplement, Aspen Publishers division of Wolters Kluwer Law & Business, New York, NY, 1995 & 2009.

Key Agreements: Stock Purchase, Stockholders, Employment, Chapter 10 in Equity Finance: Venture Capital, Buyouts, Restructurings, and Reorganizations (2nd ed.) by Joseph W. Bartlett (pp 211-252), Aspen Publishers division of Wolters Kluwer Law & Business, New York, NY, 1995.

20 Lecture 5: Motivating managers

Readings:

Executive Compensation, Stephen F. O'Byrne, Chapter E9 in Handbook of Modern Finance, edited by Dennis Logue and James Seward, Warren, Gorham & Lamont RIA Group, Boston, MA, 1999.

O'Byrne, Stephen F. and S. David Young, Six Factors That Explain Executive Pay (and its Problems), *Journal of Applied Corporate Finance* (Spring 2010), pp. 109 – 117.

Wruck, Karen H., Private Equity, Corporate Governance, and the Reinvention of the Market for Corporate Control, *Journal of Applied Corporate Finance* (Summer 2008), pp. 8 – 21.

22 Case 3: Donald Salter Communications, Inc. (structuring compensation in a private firm)

IV. Financing

27 Case 4: Coleco Industries, Inc. (choosing the appropriate financial policy)

Reading: Scan Chapters 14-16 on Capital Structure in Corporate Finance by Jonathan Berk and Peter DeMarzo, Boston, MA, Pearson/Addison-Wesley, 2007. (*in your BA385T Text*)

29 Case 5: Noble Group (financing a business)

Oct. 4 Case 6: Petrolera Zuata, Petrozuata C.A. (project finance)

6 Case 7: Athens Ring Road (Attiki Odos) (project finance and infrastructure projects)

11 Lecture 6: Leasing Policy

Reading: Note on leasing policy

13 **Midterm exam (Time and location TBD)**

V. Valuation

18 Case 8: Berg Electronics Corporation (general valuation methods)

Reading: Ruback, Richard S., Capital Cash Flows: A Simple Approach to Valuing Risky Cash Flows, *Financial Management* (Summer 2002), pp. 85-103.

- 20 Case 9: IBP (LBO valuation)
 Readings:
 Dillon, Nancy, DLJ Knows Where the Beef Is, *New York Daily News* (October 3, 2000)
 Mehring, Jaine I., Analyst Report on IBP, Inc., SalomonSmithBarney, October 2, 2000, pp. 1– 4.
 McMillin, John. M. and Jeffrey G. Kanter, Analyst Report on IBP, Inc., Prudential Securities, October 3, 2000, pp. 1– 5.
 Mehring, Jaine I., Analyst Report on IBP, Inc., SalomonSmithBarney, October 2, 2000, pp. 1– 9.
- 25 Case 10: Bidding for Hertz: Leveraged Buyout (LBO valuation)
- 27 Case 11: Comerica Incorporated: The Valuation Dilemma (valuing a financial institution)
- Nov. 1 Case 12: Sprigg Lane (A) (evaluating risk)
 Reading: Monte Carlo Simulation, Section 10.2 in Chapter 10 of Principles of Corporate Finance (6th ed.) by Richard A. Brealey, Stewart C. Myers, and Franklin Allen, New York, NY, McGraw Hill/Irwin, 2000, pp. 268 - 275.

VI. Strategies for creating value

- 3 Lecture 7: Corporate restructuring and reorganization
 Reading: Corporate restructuring and Reorganization, James K. Seward, Chapter E8, E9 in Handbook of Modern Finance, edited by Dennis Logue and James Seward, Warren, Gorham & Lamont RIA Group, Boston, MA, 1999.
- 8 Case 13: Ford Motor Company's Value Enhancement Plan (A) (recapitalization)
- 10 Case 14: Cumberland Worldwide Corporation (A) (financial restructuring in distress)
- 15 Case 15: WL Ross and Plascar (restructuring a business)
- 17 Case 16: NEC Electronics (restructuring a business)
- 22 Case 17: Service Corp. International (mergers and acquisitions and value drivers)

VII. Exit strategies

- 24 Lecture 8: Exit strategies
 Readings:
 Exit Strategies: Structuring IPO or Sale of VC-Financed Portfolio Company, Chapter 9 in Structuring Venture Capital, Private Equity, and Entrepreneurial Transactions by Jack S. Levin (pp 9-1 to 9-49), Aspen Publishers division of Wolters Kluwer Law & Business, New York, NY, 2009.
 Initial Public Offerings, Jay Ritter, Chapter D11, E9 in Handbook of Modern Finance, edited by Dennis Logue and James Seward, Warren, Gorham & Lamont RIA Group, Boston, MA, 1999.

Lazard, Robert Berger, SPACs: An Alternative Way to Access the Public Markets, *Journal of Applied Corporate Finance* (Summer 2008), pp. 68 – 75.

- 29 Case 18: Transportation Displays Incorporated (C) (alternative exit strategies following a successful corporate turnaround)

VIII. Conclusion

- Dec. 1 Lecture 9: Summary and course wrap-up
8 Final case due by 9:00 a.m.

Instructions for Preparing Written Case Analyses

Case Analysis

1. Read the case carefully. Identify the significant points and relationships. Use the exhibits to help you understand and/or interpret the text.
2. Analyze the data presented in the case and evaluate it in light of the situation. Try to understand not only the present situation, but also its historical origin and how it developed.
3. Decide what the major problems are and, if appropriate, prioritize them.
4. With the problems in mind, identify the feasible alternative courses of action. Determine what additional information is necessary to evaluate the alternative courses of action. Obtain that additional information.
5. Decide what your specific recommendation is to be. In doing so, use your understanding of the alternatives to frame a solution to the problem(s), and predict and evaluate the probable consequences of your solution.
6. Decide how you will organize the presentation of your solution to the case.

Document Organization

1. **Problem Statement:** Identify the problem(s) concisely, using whatever case facts are necessary to show significance and/or priority.
2. **Analysis:** Avoid generalities. Be as specific as possible. Express your ideas clearly, supporting them adequately with evidence, explanation, and references to appropriate exhibits. The strengths and weaknesses of alternative courses of action should be developed. The analysis should build to support your recommendation. Reasons for accepting or rejecting alternatives should be stated and, if necessary, defended.
3. **Recommendation:** State your recommendation clearly and in detail sufficient to guide implementation. Discuss both the positive and negative results of following your recommendation and why you think that it is the appropriate course of action. Make sure that the recommendation follows logically from your analysis.

Document Format

The case solution will be written as a report to senior management. The first page should provide a short executive summary that is no more than one three or four sentence paragraph in length. The detailed analysis should be presented on the following pages. All pages should be numbered and the document typed with one-inch margins and double spacing. Use a 10 point font or larger. Tables, Charts, spreadsheets, or any other supporting materials may be attached as exhibits. Each exhibit must be referred to in the text and clearly labeled.