

The Wharton School
Corporate Finance (1008-301)

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Fall 2022

FNCE 1008-301: Corporate Finance (Honors)

FNCE [1008]-301 MonWed 1:45–3:15pm Room G86 JMHH

1 Course Description

The Honors course is a version of the introductory (CORE) finance class. Here's the description of that *non-Honors* class that every Wharton UG Student must take:

The purpose of this course is to introduce techniques of financial analysis, with applications to corporate finance. The concepts developed in Finance 100 form the foundation for all elective finance courses. The main topics covered include (1) the time value of money and the net present value rule; (2) valuation of bonds and stocks; (3) capital budgeting decisions; (4) uncertainty and the tradeoff between risk and return; (5) corporate financing decisions; and (6) options.

Now here is a supplementary paragraph that I would use to describe this HONORS class:

*The honors section takes a slightly more analytic approach, explaining the logical reasons (“WHY”) and the operational aspects (the “HOW”) while exposing students to the institutional aspects of markets and market mechanisms. It is a wider exposure to the subfields – they are the focus of follow-on electives in Corporate Finance, Investment Banking, Investments including Equities, Bonds & Options, Valuation including Private Equity and Mergers & Acquisitions. All the electives will rely on the use of financial (“capital”) markets and that’s emphasised. A minimal level of effort beyond the alternative core offering in this version – reading, mostly – that will broaden your knowledge base beyond the textbook learning, aid in critical thinking as befits a seminar, and be tinged with a sense of **fun**. I try to run the honors course in a way that will appeal to all UGs (**not just intended finance majors & Wharton students, and not just sophomores!**) who like the deeper dive into the WHY and the HOW.*

Like most honors-level classes the course is run like a small-enrollment *seminar*, and it's not graded on a curve. The minimum grade I have given to those who attend, participate, turn in the work and remain intellectually engaged is a B-Plus; the majority get an A-minus or higher.

Knowledge of basic statistics, basic calculus and simple regression analysis is assumed.¹ These prerequisites are satisfied by most UGs because they have taken AP Math at the A/B level in high school, and possibly even AP Stat or Math 104/110/114; or they have taken STAT101. Familiarity w Microsoft Excel is highly recommended and easily picked up; knowledge of R, Python or STATA would be great but not required.

For more detailed information about the class, its coverage, and its prerequisites, just call me (215) 898-6206 on Tu-Thu afternoons 1:30-3:30pm; be sure to leave a message. Better still, email me at krishna@upenn.edu with questions but do include your tel number, as it's efficient to chat briefly and answer follow on questions.

¹Course numberings have been changed; rather than refer to the new course numbers in what follows I give the old (eg STAT101) numbers along w a title!

Text

Course Material

- Required: **Lecture Slides & Course Notes** that will be made available on CANVAS.
- Recommended: *Fundamentals of Corporate Finance* by Berk, DeMarzo & Harford, 5th Ed. Pearson henceforward **BDH**. The eText is downloadable from Pearson.

You should have access to this book. I treat it as companion reading...it will round out your knowledge.

Much of the text is easy reading; many of the chapter-ending problems are reinforcing, especially if you've read the text, and I will suggest that you work out selected Problems that are more challenging. Also available is the solutions manual, I plan to place at least one copy on Lippincott Reserve by the second week's end; I will have one copy available with me so that you can borrow it during the week and keep it over the weekend as needed. My homework assignments will select a few of these problems, but I will make up the remaining questions.

- A scientific or business calculator, for use in HWs and exams. It will be necessary for your calculator to have a x^y function. Most calculators have the basic financial functions you need: for your work at home it's best to have access to Excel.

2 Course-related Information

Office & Hours

SHDH 3259, Campus 'phone 8-6206, email:: krishna@wharton.upenn.edu

Hours: Tues 1:15-2:50pm and Thurs 11:00-noon. I'll be in during these hours.

With the seminar-style nature of the course and the small section, I have an open door policy at other times on M-Thu, but it's wise to email or call prior to coming!

Teaching Assistants

Benjamin David our FNCE PhD student is the Course TA. He will hold weekly office hours (in SHDH 2400, precise location TBA) and run a review session esp prior to the midterms. I will post his hours on Canvas in the first week after his class schedule is known.

Weekly Memos!!!

Every Thursday night I send an email to all of you. It summarizes what was covered that week, and what will be covered the following week; it will have information on Problem Sets, Exams and so on, as reminders! *don't ignore these emails!* Those of you who are non-Wharton students must send me an email if you do not receive it after the first full week... I may also post a copy of important emails on Canvas.

Course Requirements

Your **COURSE GRADE** will depend on your performance on:

- Four problem sets to be done *individually*; many more practice problems and solutions will be made available. [20%]
- One computer exercise, *to be done in groups of no more than two students* in which you will compute measures of risk, value a chosen firm's equity, and assess its cost of capital; [10%]
- Two **in-class midterm exams**, one on 12 October and the other on 21 November; one sheet of formulas and notes permitted.[Total 40%]
- One In-class Quiz – given in the final week, mostly conceptual Qs [10%]
- Class *Preparedness & Participation*: I call on people to share their ideas on material that was assigned or covered the previous week. You should stay on top of the readings and assignments and try to answer the questions.[18%]

All exams are cumulative – i.e. they will cover material up to and including the week before the exam, although the material since the last exam will be given emphasis. Prior to each midterm the TA will run review sessions and the TA & I will have extended office hours.

Your Calendars

Mark the following dates into your calendars: as you can see, there is a steady flow of work demanded in this course!

Date	Event	Remarks
Thu 15 Sep	Problem Set 1 Due	By 4pm in my office 3259SHDH
Thu 29 Sep	Problem Set 2 Due	By 4pm in my office 3259SHDH
Wed 12 Oct	Midterm 1 Exam	<i>In Class</i>
Thu 20 Oct	Problem Set 3 Due	By 4pm in my office 3259SHDH
Mon 14 Nov	Problem Set 4 Due	By 4pm in my office 3259SHDH
Mon 21 Nov	Midterm 2 Exam	<i>In Class</i>
Wed 07 Dec	In Class Quiz	
Mon 12 Dec	Last Day of Class	
Tue 13 Dec	Group Assignment Due	My Office 3259 SHDH

Problem Sets will be distributed in Class the week or more before they are due. Each Problem Set is due on a Thursday; I upload a *preliminary version* on Canvas at least 12 days in advance when you can *begin* working on it; I add a few problems each day on material that's covered as we go along. On the Friday immediately prior to the Tuesday the assignment is due, the version will be marked *final*. This encourages you to start working on the Problem Set typically 12 days in advance (!!!) and keep working on it as I add problems to the preliminary version, and finish it off the weekend before it's due. This promotes a steady effort and encourages revision of the material we cover... and it builds character!

Detailed Topics Outline

Here is a description of the topics we cover, with links to the Text's chapters. At this stage, the lectures needed for its coverage are tentative, so you should take these as approximate. Always rely on my Weekly Emails to review materials for the recently-concluded week, and to read suggested material for the following week.

Remember: the slides for each week will be posted on Canvas at the beginning of the week: **you must print them and bring them to class!**

Abbreviations: *Text* refers to **BDH**; numbers in **bold** are **required chapter readings**; numbers in *[square brackets]* are **optional chapter reading**.

Please keep in mind that the weekly email I send each Thursday will point you to specific readings and supplemental material on Canvas... the following is intended as a guideline!

1. Introduction, FinMath & The Net Present Value Procedure

Following a brief introduction and a quick review of Financial Math – it's useful to resolve ambiguous lingo and jargon early! — we begin by developing basic ideas of Valuation and Discounted Cash Flow (DCF) often called the Net Present Value (NPV) approach. This is *the* very basic analytical tool in finance, which will be repeatedly used in different contexts and with increasing levels of sophistication in modeling. Some items we will learn along the way: *simple and compound interest, Present and Future Values; valuing an annuity, a perpetuity, a bond; the effective annual interest rate*. We learn how to compute payments and remaining values in a conventional fixed rate mortgage and a term loan; and to enable savings-investment calculations that befuddle lay people.

BDH [Chapters 1,2 Background Reading], Required Reading: 3,4

2. Fixed Income Valuation

The market for fixed income instruments (commonly referred to as the *Bond Market*) is huge; governments (e.g. the US Treasury), government agencies, municipalities and corporations all borrow money on this organized market. We study the markets for Treasury Bills and the valuation of pure discount bonds; we'll use the prices of these bonds to value coupon bearing bonds, define their associated *yields-to-maturity* and make a connexion between these yields and the constellation of forward rates, which are rates quoted today for arranging a loan(borrowing) or an investment(lending money) with both start dates and repayment dates in the future. This discussion will culminate in the development of the *yield curve*.

BDH 5,6

3. Investment Rules

In viewing a prospective security (such as a share) when its market price is observable it is natural to compare the value we place on that security to its market price – and in answering that question we are led to ask whether the security offers a return that is higher or lower than some acceptable yardstick. This leads to the development of an internal rate of return (IRR) calculation which is oftentimes used as another valuation tool to assess prospective investments or projects. We'll compare the NPV and the IRR approach in this accept or reject decision, and in cases where we must choose among mutually exclusive opportunities; and discuss other rules (payback and profitability).

BDH 8

4. Stock Valuation

We now apply the DCF method to value a share of a company's stock: a prospective buyer of a share of common stock anticipates a stream of cash dividends paid by the company out of its earnings each

period... in a series of small steps we move from valuing this stream assuming the firm is infinitely-lived; then assuming a pattern of growth to the dividend stream over a finite period, perhaps with several stages of growth to becoming a mature firm; and analyzing what value accrues to the firm's future growth opportunities that rely on patents and R & D. I have to add that the Core class interleaves this topic with so many other topics and concepts that you will see the same issues time and again, which is all to the good. *BDH 7*

5. Capital Budgeting

Here we will confront the important managerial choice of computing the NPV of projects and investment proposals in practical contexts... there is no better way to do this than by example, and we'll do several. That's the best way to learn this subject. Here we must take practical considerations into account: accounting for depreciation in computing the cash flows from an investment, taking the effect of inflation, and comparing investments with different lives (horizons).

BDH 8,9

6. Risk and Return: computation and statistical measures

We'll study the behavior of returns to common stocks and bonds, over various horizons; we'll study their distributional properties (as random variables), developing notions of expected returns, standard deviations and correlations. We'll move to asking the natural question: what happens to our prospective return as we form portfolios (invest fractions of our wealth in several securities) – and we'll study the behavior of the expected return and risk measures of multiple-asset portfolios. We'll decompose – *parse* is a better word – the total risk of holding a security or a portfolio of securities into component sources, sometimes called systematic (or non-diversifiable) and unsystematic (or unique or idiosyncratic) risks, and demonstrate that the former is averaged in portfolios but the latter can be diversified away.

BDH 11

7. Asset Pricing Models

A natural question to ask is whether by aggregating the demands of risk-averse investors for bonds and stocks, and aggregating the supplies of these assets from corporations and others we can find an equilibrium relationship between the *expected return* to an asset (a reward for bearing risk) and its *risk* – and we study alternative *asset pricing models* but briefly. We will also cover subtopics in Market Efficiency (Chapter 10, section 10.4 along the way). And we must leave a little something for later electives to cover!

BDH 11,10.4

8. The Capital Structure Decision

We've covered one important decision that financial managers make – that of choosing between risky projects in capital budgeting – and we discussed the Net Present Value Rule as a natural check of benefits over costs in present value terms. Here we'll study the capital structure decision: the way we *finance* or find the funds for these projects, by choosing a mix of bonds and stocks that constitute the principal forms of corporate liabilities: first in an idealised taxless world with perfect markets, and then in a world where there are taxes and costs of financial distress.

A common way people proceed in this topic is to ask what the appropriate cost of capital is for the firm; and another way is to compute the Adjusted Present Value of a potential investment, taking the costs dictated by the chosen capital structure.

BDH [15], 16]

9. The Dividend Decision

We study here the way dividend payments to common shareholders are decided; additional topics include stock dividends and stock splits, the impact of taxes, and empirical evidence on dividend payouts.

BDH 17

10. Derivatives: Forwards, Options and their Applications

Innovation in financial markets – especially in the area of derivative securities – occurs rapidly. We study the basic forms of these derivatives and some elementary applications.

Lecture Notes

11. Miscellaneous Topics:: Capital Raising by Investment Banks, The World of Mergers & Acquisitions, What Hedge Funds Do... Time Permitting

Here I'll discuss sundry topics.