CAREER CLUSTER
Finance

CAREER PATHWAY
Corporate Finance

INSTRUCTIONAL AREA
Financial Analysis

CORPORATE FINANCE EVENT

PARTICIPANT INSTRUCTIONS

PROCEDURES

1. The event will be presented to you through your reading of these instructions, including the Performance Indicators and Event Situation. You will have up to 30 minutes to review this information to determine how you will handle the role-play situation and demonstrate the performance indicators of this event. During the preparation period, you may make notes to use during the role-play situation.

2. You will have up to 15 minutes to role-play your situation with a judge (you may have more than one judge).

3. You will be evaluated on how well you meet the performance indicators of this event.

4. Turn in all your notes and event materials when you have completed the role-play.

PERFORMANCE INDICATORS

1. Discuss the capital budgeting process.

2. Discuss ways to determine the best financing option for a company.

3. Discuss the nature of corporate bonds.

4. Discuss the cost of long-term debt.

5. Explain the nature of interest rate risk.

EVENT SITUATION

You are to assume the role of corporate treasurer at GREEN HERITAGE PROPANE, a large propane distribution company located in the Midwest. The corporation has prospered over the last several years but recognizes that growth, in this mature industry, is best achieved through diversification into different types of energy including natural gas and fuel oil. Your CEO (owner) believes that an acquisition of a firm in the fuel oil segment of the industry is the first priority for GREEN HERITAGE PROPANE. In order to acquire another firm, your corporation needs to raise a significant sum of capital. Your CEO (judge) has asked you to prepare a presentation to the corporation's Board of Directors that fully explains how you might secure the needed financing in the bond market.

After conducting research and consulting with your securities broker, your plan is to raise the cash by issuing 10,000, $1000 face value bonds that carry a coupon rate of 6% paid semiannually; the bonds will mature in seven years. The yield to maturity (YTM) on your corporate bond is anticipated to be 6% and your bond issue is expected to be rated by Standard & Poor's as BBB. As you have prepared for the issue, market rates of interest have become quite volatile, which will affect the price of the bond on the date of issue. This will be the first bond issue for the corporation, and the CEO (judge) feels that it is a worthwhile task to fully educate the Board about how bond financing really works.

Specifically, the CEO (judge) has asked you to cover the following information: 1) options for raising capital in the securities market; 2) bond basics including all basic language and concepts; and 3) bond prices for the company issue under two different scenarios:

- The YTM falls to 5.50%
- The YTM rises to 6.50%

You will rehearse your presentation with the CEO (judge) prior to the presentation to the Board. Your rehearsal will take place in the CEO's (judge's) office. The CEO (judge) will begin the role-play by greeting you and asking to hear your presentation. After you have finished and have answered the CEO's (judge's) questions, the CEO (judge) will conclude the role-play by thanking you for your work.

JUDGE'S INSTRUCTIONS

DIRECTIONS, PROCEDURES AND JUDGE'S ROLE

In preparation for this event, you should review the following information with your event manager and other judges:

1. Procedures

2. Performance Indicators

3. Event Situation

4. Judge Role-play Characterization
   Participants may conduct a slightly different type of meeting and/or discussion with you each time; however, it is important that the information you provide and the questions you ask be uniform for every participant.

5. Judge's Evaluation Instructions

6. Judge's Evaluation Form
   Please use a critical and consistent eye in rating each participant.

JUDGE ROLE-PLAY CHARACTERIZATION

You are to assume the role of the CEO at GREEN HERITAGE PROPANE, a large propane distribution company located in the Midwest. The corporation has prospered over the last several years but recognizes that growth, in this mature industry, is best achieved through diversification into different types of energy including natural gas and fuel oil. You believe that an acquisition of a firm in the fuel oil segment of the industry is the first priority for GREEN HERITAGE PROPANE. In order to acquire another firm, your corporation needs to raise a significant sum of capital. You have asked your corporate treasurer (participant) to prepare a presentation to the corporation's Board of Directors that fully explains how you might secure the needed financing in the bond market.

You have identified a fuel oil company that is a good fit based on its geographic market saturation and the fact that the current owner of the family-owned business is ready to retire. The business has recently been put up for sale and you believe that a deal can be made for $10 million in cash. In the past, GREEN HERITAGE PROPANE's Board of Directors has been unwilling to issue additional stock in order to raise capital, so your directive to the treasurer (participant) is to raise the cash by executing a bond issue.

Your treasurer reports (participant) that after conducting research and in consulting with your securities broker, his plan is to raise the cash by issuing 10,000, $1000 face value bonds that carry a coupon rate of 6% paid semiannually; the bonds will mature in seven years. The yield to maturity (YTM) on your corporate bond is anticipated to be 6% and your bond issue is expected to be rated by Standard & Poor's as BBB. As you have prepared for the issue, market rates of interest have become quite volatile, which will affect the price of the bond on the date of issue.

This will be the first bond issue for the corporation, and you feel that it is a worthwhile task to fully educate the Board about how bond financing really works.

Specifically, you have asked your treasurer (participant) to cover the following information: 1) options for raising capital in the securities market; 2) bond basics including all basic language and concepts; and 3) bond prices for the company issue under two different scenarios:

- The YTM falls to 5.50%
- The YTM rises to 6.50%

The treasurer (participant) will present to you in a role-play to take place in your office. You will begin the role-play by greeting the treasurer (participant) and asking to hear about his/her ideas.

During the course of the role-play you are to ask the following questions of each participant:

1. How would a longer maturity bond affect pricing on the bond issue? Might a 15 or 20 year bond be a better choice for the company?

2. What are the advantages of a bond issue over more traditional borrowing, say, from a bank or other commercial lender?

3. For future acquisitions, should the Board consider a stock issue? What are the pros and cons?

Once the treasurer (participant) has made his/her presentation and has answered your questions, you will conclude the role-play by thanking the treasurer (participant) for the work.

You are not to make any comments after the event is over except to thank the participant.

SOLUTION

The most obvious **options for raising capital** **(cash)** in the securities market are:

- Issue stock – sell additional shares of common stock
- Issue bonds – borrow cash

The two options are fundamentally different.

- If a company raises capital (cash) using **equity** (stock), there is LESS corporate risk. The company does not need to pay back any of the raised capital and is not required to pay a dividend. HOWEVER, the equity investor demands a higher expected return (ROE) on their investment than the bondholders.

- If a company raises capital (cash) using **debt** (bonds) there is MORE corporate risk. The lender (bondholder) requires that periodic interest be paid and the principle must be paid back in full when the bond matures. When there is more risk, there is a greater expected return. The company would expect to generate a greater return when they finance their investments in assets using DEBT.

<u>Bond basics – concepts and terminology</u>
A bond is a long-term (more than 1 year) security (investment) that shows evidence of debt (borrowed $). The issuer of the bond (U.S. government, municipality, college, <u>corporation</u>) will pay interest twice/year (semiannually) on the bond AND they will repay the loan amount (principal) at maturity.

Coupon**:** The regular, fixed amount interest payment made by the issuer on the bond. This amount NEVER changes over the life (maturity) of the bond. Coupon payments are made twice annually (semi-annual).

Face Value**:** Also called Par Value or Principle – the amount that will be repaid at the bond's maturity. It is typically $1,000. The loan amount.

Coupon Rate: The rate when multiplied by the face value determines the annual coupon or interest payment on the borrowed money.

Maturity: The date on which the principle amount (face value) of the bond is repaid.

<u>Bond pricing</u>
The price of the bond is equal to the present discounted value (PV) of the cash flows that the bond is expected to generate. A bond has two different cash flows – regular coupon payments and the repayment of the principal at maturity.

Bond Price = PV of the Coupon Payments + PV of the Principal at Maturity

Bond prices vary INVERSELY with yields – because cash flows are discounted at the YTM
The higher the YTM – the lower the bond price
The lower the YTM – the higher the bond price

If the YTM falls to **5.50%,** the price of the bond will rise above the bond's face value – it will be issued at a premium – this will reduce the expense of borrowing. The firm will receive more cash than anticipated, yet at maturity they will only repay the face value.
GREEN HERITAGE PROPANE Bonds when YTM is 5.50% will equal: $1,028.73

If the YTM increases to **6.50%,** the price of the bond will fall below the bond's face value – it will be issued at a discount – this will increase the expense of borrowing. The firm will receive less cash than anticipated, yet at maturity they will repay the face value.
GREEN HERITAGE PROPANE Bonds when YTM is 6.50% will equal: $972.24

As **<u>market interest rates change</u>**, the present value of the bond's future cash flows change. The interest rate required in the market on a bond is called the bond's yield-to-maturity (YTM), or "yield" for short. The interaction of supply and demand determines the yield and therefore the price of the bond.

- When yields fall –prices increase - <u>supply</u> increases (more companies issue bonds)
- When yields rise – prices decrease – <u>demand</u> Increases (more investors buy bonds)

Bond ratings

The risk that a bond issuer may default on its obligations is called default or credit risk. In order to compensate for this default risk, corporations need to promise higher rates of interest. The greater the chance that the issuing company will get into trouble, the higher the default premium demanded by investors. The safety of most corporate bonds can be judged from bond ratings provided by Standard & Poor's or Moody's.

AAA thru AA = High credit quality investment
AA thru BBB = Medium credit quality investment
BB, B, CCC, CC, C = Low credit quality investment
D = bonds in default (unable to pay principal +/or interest)

Higher the rating = greater credit worthiness, less risk and therefore lower yields
Lower the rating = greater risk of default, more risk and therefore higher yields

<u>Key points (answers to judge's questions):</u>

- Longer maturity bonds?
  - In general, longer term bonds pay higher interest rates. The primary reason for this is that investors are locking up their money longer, and are taking on more interest rate risk.
  - Longer term bonds are also subject to much more pronounced price swings.

- Traditional borrowing from a bank or commercial lender instead of through a bond issue?
  - Generally speaking, a bank loan is more suitable for short term borrowing needs
  - Most banks charge adjustable rates of interest, exposing the corporation to changes in market interest rates. Lenders are also capable of substantially changing the terms of the deal.
  - Smaller regional corporations are sometimes unable to use bond financing if they have no reputation in the bond market - they need to prove their credit quality, which will then determine the risk price of the investment.

- Future accumulation of capital from a stock issue?
  - The debt versus equity financing decision is ultimately dependent on the long-term goals of the business and the amount of control managers wish to maintain.
  - Ideally, experts suggest that businesses use both debt and equity financing in a commercially acceptable ratio.
  - This ratio, known as the debt-to-equity ratio, is a key factor analysts use to determine whether managers are running a business in a sensible manner. Although debt-to-equity ratios vary greatly by industry and company, a general rule of thumb holds that a reasonable ratio should fall between 1:1 and 1:2.

JUDGE'S EVALUATION INSTRUCTIONS

Evaluation Form Information

The participants are to be evaluated on their ability to perform the specific performance indicators stated on the cover sheet of this event and restated on the Judge's Evaluation Form. Although you may see other performance indicators being demonstrated by the participants, those listed in the Performance Indicators section are the critical ones you are measuring for this particular event. Please note that an overall score of 70% indicates a *minimum level of acceptable performance.*

Evaluation Form Interpretation

The evaluation levels listed below and the evaluation rating procedures should be discussed thoroughly with your event chairperson and the other judges to ensure complete and common understanding for judging consistency.

Level of Evaluation	**Interpretation Level**
Exceeds Expectations	Participant demonstrated the performance indicator in an extremely professional manner; greatly exceeds business standards; would rank in the top 10% of business personnel performing this performance indicator.
Meets Expectations	Participant demonstrated the performance indicator in an acceptable and effective manner; meets at least minimal business standards; there would be no need for additional formalized training at this time; would rank in the 70-89th percentile of business personnel performing this performance indicator.
Below Expectations	Participant demonstrated the performance indicator with limited effectiveness; performance generally fell below minimal business standards; additional training would be required to improve knowledge, attitude and/or skills; would rank in the 50-69th percentile of business personnel performing this performance indicator.
Little/No Demonstration	Participant demonstrated the performance indicator with little or no effectiveness; a great deal of formal training would be needed immediately; perhaps this person should seek other employment; would rank in the 0-49th percentile of business personnel performing this performance indicator.

JUDGE'S EVALUATION FORM
CORPORATE FINANCE
STATE EVENT 2 - 2013

DID THE PARTICIPANT:

1. Discuss the capital budgeting process?

Little/No Demonstration	Below Expectations	Meets Expectations	Exceeds Expectations
0, 1, 2, 3, 4, 5	**6, 7, 8, 9, 10, 11**	**12, 13, 14, 15**	**16, 17, 18**
Attempts at discussing the capital budgeting process were inadequate or weak.	Adequately discussed the capital budgeting process.	Effectively discussed the capital budgeting process.	Very effectively discussed the capital budgeting process.

2. Discuss ways to determine the best financing option for a company?

Little/No Demonstration	Below Expectations	Meets Expectations	Exceeds Expectations
0, 1, 2, 3, 4, 5	**6, 7, 8, 9, 10, 11**	**12, 13, 14, 15**	**16, 17, 18**
Attempts at discussing ways to determine the best financing option for a company were inadequate or weak.	Adequately discussed ways to determine the best financing option for a company.	Effectively discussed ways to determine the best financing option for a company.	Very effectively discussed ways to determine the best financing option for a company.

3. Discuss the nature of corporate bonds?

Little/No Demonstration	Below Expectations	Meets Expectations	Exceeds Expectations
0, 1, 2, 3, 4, 5	**6, 7, 8, 9, 10, 11**	**12, 13, 14, 15**	**16, 17, 18**
Attempts at discussing the nature of corporate bonds were weak or incorrect.	Adequately discussed the nature of corporate bonds.	Effectively discussed the nature of corporate bonds.	Very effectively discussed the nature of corporate bonds.

4. Discuss the cost of long-term debt?

Little/No Demonstration	Below Expectations	Meets Expectations	Exceeds Expectations
0, 1, 2, 3, 4, 5	**6, 7, 8, 9, 10, 11**	**12, 13, 14, 15**	**16, 17, 18**
Attempts at discussing the cost of long-term debt were inadequate or weak.	Adequately discussed the cost of long-term debt.	Effectively discussed the cost of long-term debt.	Very effectively discussed the cost of long-term debt.

5. Explain the nature of interest rate risk?

Little/No Demonstration	Below Expectations	Meets Expectations	Exceeds Expectations
0, 1, 2, 3, 4, 5	**6, 7, 8, 9, 10, 11**	**12, 13, 14, 15**	**16, 17, 18**
Attempts at explaining the nature of interest rate risk were inadequate or weak.	Adequately explained the nature of interest rate risk.	Effectively explained the nature of interest rate risk.	Very effectively explained the nature of interest rate risk.

6. Overall impression and response to the judge's questions.

Little/No Demonstration	Below Expectations	Meets Expectations	Exceeds Expectations
0, 1, 2	**3, 4, 5**	**6, 7, 8**	**9, 10**
Demonstrated few skills; could not answer the judge's questions.	Demonstrated limited ability to link some skills; answered the judge's questions adequately.	Demonstrated the specified skills; answered the judge's questions effectively.	Demonstrated skills confidently and professionally; answered the judge's questions very effectively and thoroughly.

Judge's Initials ______________________ **TOTAL SCORE ___________________**

Tiebreaker: 2, 3, 4, 5, 1, 6