

NEW YORK UNIVERSITY - LEONARD N. STERN SCHOOL OF BUSINESS

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Topics in Investments: Investing in Distressed Securities

Spring 2016

Wednesdays 6:00 – 9:00 pm (February 10 – March 23; no class March 16 (spring break))

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Office hours by appointment

Brad Eric Scheler

Fried, Frank, Harris, Shriver & Jacobson

Objective: To prepare students to understand, evaluate, and invest in distressed corporate situations and securities. Students will be exposed to the distressed process from a number of different viewpoints (management, trade vendors, senior lenders, subordinated lenders, legal and financial advisors, DIP lenders, bankruptcy courts, vulture investors, distressed debt traders/brokers) to better understand the roles, agendas, and objectives of each of the participants and how they affect investment results.

Course Prerequisites

- Basic accounting and financial statement analysis
- Basic knowledge of fixed-income and equity securities and related mathematics
- Basic corporate finance (discount cash flow analysis)
- Basic common sense
- Extraordinary enthusiasm and effort

Optional textbooks and reference materials

- Corporate Financial Distress and Bankruptcy, 3rd Edition
Edward I. Altman and Edith Hotchkiss (Wiley, 2005)
- Distress Investing: Principles and Technique
Martin J. Whitman and Fernando Diz (Wiley, 2009)
- Distressed Securities
Edward I. Altman (Beard Books, 1999)
- Distressed Debt Analysis; Strategies for Speculative Investors,
Stephen G. Moyer (J. Ross Publishing, 2004)
- The Vulture Investors (revised edition)
Hilary Rosenberg (Wiley, 2000)
- Bankruptcy Investing – How to Profit from Distressed Companies
Ben Branch and Hugh Ray (Beard Books, 2007)
- Creating Value Through Corporate Restructuring: Case Studies in Bankruptcies, Buyouts, and Breakups
Stuart C. Gilson (Wiley, 2001)
- The Dark Side of Valuation: Valuing Young, Distressed, and Complex Businesses, 2nd Edition
Aswath Damodaran (FT Press, 2009)
- Bankruptcy Code, Rules, and Official Forms; 2010 Law School Edition
(Thompson West, 2007)
- A good online site to reference the code is: law.cornell.edu/topics/bankruptcy.html
- Other materials and case studies will be distributed in class

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Structure: The course will use a combination of lectures, case discussions, reading assignments, and guest lectures.

Lectures:

Lectures will focus primarily on the bankruptcy/reorganization process, valuation methods, and special issues including, for example, issues related to claim seniority/subordination and stepdowns, estimating rejected executory contract claims, indenture analysis, and industry specific considerations. Recent academic research relevant to the area will also be discussed.

Case Analyses:

Three (3) case studies will be distributed in class. Cases will be based on recently concluded or pending distressed situations and utilize a combination of consolidated facts and actual financial and bankruptcy court documents. Each case will stress a key evaluation aspect. Write-ups can be a maximum of 2 pages of text (single space with generous font and margins) plus unlimited exhibits, and will address specific questions. Group write-ups are perfectly acceptable (maximum of 3 persons in a group, please); keep in mind that a group of x people submitting a write-up should demonstrate a proportional increase in effort. Group papers can be a maximum of 3 pages in length (plus maximum of 6 pages of exhibits). As a final point, please realize that quality and quantity are mutually exclusive (i.e. don't feel the need to fill up the page with fluff). Feel free to work on cases solo, if you wish.

Tips for good case studies (in my opinion, if that matters)

- Try to deliver a professional-looking work product
 - It's a reflection of the effort you put into the project
 - It indicates that you're serious
 - It's usually easier to read
- Make sure your conclusions and statement make common sense
 - Don't rely on quantitative output of a model if results seem out of line; take a step back and ask yourself if everything makes sense
 - Double-check for simple calculation errors and modeling mistakes; here it's only your grade; out there, it could be your job that's at risk
- If the case asks specific questions, make sure you give specific answers
- In exhibits, use arrows, circles, bold font, and comment boxes to point out relevant information that supports your case or that you'd like to emphasize
 - The less effort it takes me to find it, the happier I will be
- General Format (for investment recommendation)
 - Please start out with 2-4 sentences summarizing your investment recommendation
 - Investment recommendation should include:
 - What to do (e.g. buy, short, or hedged trade) and at what price
 - Target price => Expected absolute total return (%)
 - Time frame => expected annualized return (%)
 - Rest of text
 - Investment rationale supported by data, evidence, and exhibits
 - Identification of risks to your thesis (try to quantify)
 - Other potential ways to structure trades

Reading Assignments: Current topics and primers. Students are expected to be able to discuss.

Guest Lectures:

Prominent professionals in the industry will discuss a variety of topics related to distressed investing. **ATTENDANCE IS MANDATORY AND WILL BE RECORDED.**

Grading:	Case summaries	100%
	Class participation*	+/-
		100% (+/-)

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Lecture and Case Study Schedule

1	<p>Introduction to investing in distressed securities Distressed vs. Defaulted Securities Example of a distressed investment from start to finish <i>Case 1 distributed: Evaluating a distressed bond; enterprise valuation; distribution to creditors</i></p>
2	<p>Historical Perspective The high yield and leveraged loan markets Distressed Investing – Overview Life cycle of Corporate Distress and Reorganization Investment Strategies – Choices and Drivers Distressed Credit Analysis Trading Conventions Analytical tools EBITDA vs. GAAP accounting Evaluating the corporate and capital structure of the firm Market value of the enterprise Interest coverage ratios; cash vs. non-cash interest expense Liquidity measures and availability Estimating normalized operating numbers of the going-concern Estimating debt capacity Estimating the liquidation value of a firm. Using DCF and cash-flow multiples to value the enterprise <i>Case 1 discussion</i> <i>Case 2 distributed: Indenture and Credit Agreement Analysis</i></p>
3	<p>Indenture and Credit Agreement analysis: What to look for as an investor and implications for security valuation History of the Trust Indenture Evolution and purpose of covenants Typical affirmative and negative covenants Modifications, supplements, and waivers Events of default Defaulted Credit Analysis Valuation Debt Capacity Capital Structure Analysis Capital Structure Arbitrage Contractual vs. Structural Subordination Guarantees Examples Balance sheet restructuring</p>

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Lecture and Case Study Schedule

(continued)

4	<p>Bankruptcy and Insolvency Law Brief history of bankruptcy Cost of Bankruptcy Chapter 11 Process Bankruptcy and Consumer Protection Act of 2005 Operating as a Debtor in Possession; DIP Financing The automatic stay Executory contracts and unexpired leases Exclusivity Adequate protection and post-petition interest Creditors' committee(s) Cramdown Best interests test Plan of Reorganization and Disclosure Statement Emerging from Chapter 11; Exit Financing; Credit Bidding, Rights offerings and other capital infusions Chapter 7 liquidation</p> <p><i>Case 2 discussion</i> <i>Case 3 distributed: Evaluation of a Plan of Reorganization and Disclosure Statement</i> GUEST LECTURER: BRAD SCHELER</p>
5	<p>The Bankruptcy Code in more detail; implications for investors Equitable subordination Substantive consolidation Recharacterization Fraudulent conveyance and Preferences Jurisdiction Tax issues Pension plans and other post-retirement promises Issues related to current employees: retention and emergence bonuses Trustees and Examiners in Chapter 11 International Insolvency Laws GUEST LECTURER: DR. EDWARD ALTMAN</p>
6	<p>Discussion of the distressed securities industry (players, returns, investors) Applications to portfolio management Correlation to various benchmark indices Investment and trading strategies Bank Debt and Trade claims Credit Derivatives Hedging strategies and shorting securities Leverage; The Role of a Primer Broker Blocking positions Acquiring control of the firm through distressed debt Exit strategies Academic research on distressed investing Recovery rates Performance of equities of firms emerging from Chapter 11 Not so great ideas: what we can learn from bad investments <i>Case 3 discussion</i> GUEST LECTURER: BRAD SCHELER</p>