FIN 469/669: Distress Investing

Instructor Info
Fernando Diz, PhD
The Martin J. Whitman Professor of Finance
Managing Director,
The Orange Value Fund, LLC
Office: 610 WSOM
Phone (Mobile, yes you can text me): 315-575-4979
E-mail: fdiz@me.com
Twitter: @fin466 (yes, the course number does not coincide with this one, but I ran out of accounts!)

COURSE DESCRIPTION

The purpose of the course is to provide the student with the needed tools to understand and learn the discipline of distress investing. Distress investing is only one very specific form of value investing.

This is a course about business valuation, corporate finance, bankruptcy law and security analysis with an emphasis on analyzing public companies that are in financial distress, from the bottom up. This is in sharp contrast to traditional academic finance, which is heavily top down and assumes substantive consolidation between the company and its constituencies (managements, stockholders, bondholders, trade vendors, etc). We examine the company as a stand-alone, separate and distinct from shareholders, managements, creditors, etc. We study the conflicts of interest and communities of interest among these constituencies and look at the markets where those different constituencies participate, i.e. public markets, private markets, markets for corporate control, markets for distressed credit instruments, etc. Course goals include but are not restricted to: 1) To achieve a thorough understanding of how to value the assets of a bankruptcy estate; 2) To learn the mechanics of the bankruptcy process so that its rules can be used strategically to make investments in distressed securities with a view to either profit from the sale of such securities to a market or take control of companies through the bankruptcy process; 3) To review actual Chapter 11 cases and understand the intricacies of the process as well as who the players are and what their goals are. Throughout the course we find it very useful to contrast the academic view against the distress investor's view. It is recommended that the student has previously taken either FIN 256 or FIN 301 as a prerequisite to take this course.

LEARNING OUTCOMES

1. Achieve proficiency in the analysis of companies in financial distress with a view to making investments in the fulcrum securities in the company's capital structure.
2. Understand how to value the assets of the bankruptcy estate, with particular emphasis on going concern and separate and salable asset valuation techniques.
3. Learn the relevant components of the Bankruptcy code as they apply to reorganizations in Chapter 11 and liquidations in Chapter 7.
4. Understanding the bankruptcy process, its constituencies, their communities and conflicts of interests and how they affect reorganization outcomes.
5. Learn how to follow a bankruptcy case and obtain time sensitive information, which helps in the valuation of reorganization securities likely to be issued pursuant to a plan of reorganization.
6. Learn how to analyze pre and post-reorganization securities.

BOOKS AND OTHER RESOURCES

1. *Distress Investing: Principles and Technique,* by Martin J. Whitman and Fernando Diz, John Wiley & Sons 2009. **Required**
2. *Modern Security Analysis: Understanding Wall Street Fundamentals,* by Martin J. Whitman and Fernando Diz, Wiley 2013 (available on Kindle through Amazon). **Required for several sections of the course.**
3. *A Short Course in Bankruptcy Law,* by Professor Gregory Germain, provided on the course Web site.
4. *Distressed Mergers and Acquisitions, (2013)* Watchell, Lipton, Rosen and Katz.
5. *Professor Diz in-class notes.*
6. Documents to be distributed in-class electronically.

COURSE STRUCTURE AND GRADING

The structure of the course is the traditional lecture combined with in-class work on cases. The course will require a lot of reading (more than many of you are used to) and I will not bring the level of the course down to the lowest common denominator. The readings are required and this is not a soft requirement.

The grading structure will be as follows:

Cases (2):	60%
Preparedness:	40%

Below is a sketch of the topics that we shall be covering in class. Readings are indicated with endnotes.

I. INTRODUCTION

1. *A Conceptual framework for understanding any form of investing.*
    - *a.* A simple model of the firm.
    - b. Some extensions of the simple model.
    - *c.* The key to successful investing.

2. *Investing vs. speculating, Risk and return.*
    - a. Graham and Dodd's view on the subject.
    - b. The prevailing academic view on risk and return.
    - c. Understanding important sources of risk.
    - d. Summary.

II. CAPITAL STRUCTURE, LEVERAGE, CREDIT RISK (*Chapter 7 Modern Security Analysis and Class notes)*

1. What is capital structure?
2. Why companies have different capital structures?
3. Credit risk and credit support.
    - a. What is credit risk?
    - b. What is credit support?
4. A definition of leverage based on cash flow support.
5. Credit capacity.
    - a. What is credit capacity?
6. Credit capacity and corporate feasibility according to the feasibility test.
    - a. Section 1129 of the Bankruptcy code.
7. Credit capacity measured by debt repayment ability (cash flow support).
8. Credit capacity measured by the ability to amortize debt over time.
9. Credit capacity and the ability to refinance (access to capital markets).
10. Credit capacity measured by use of proceeds.
11. Credit capacity and asset coverage.
12. Credit instruments designed to "avoid" credit capacity limits.

III. THE SUBSTANTIVE CHARACTERISTICS OF SECURITIES (Chapter 4, *Modern Security Analysis*)

1. What gives a security its worth?
2. Types of securities
3. Control vs. non-control securities

IV. DOCUMENTS DEFINING THE RIGHTS OF SECURITY HOLDERS

1. Credit Agreements and Indentures (class notes)
2. Understanding the basics of credit agreements and loan deals.

    a. The loan deal, understanding the terms
    b. The structure of a deal
    c. Ways of controlling credit risk once a loan is made:
        i. Secured, under secured or unsecured?
        ii. Are there guarantees?
        iii. Upstream guarantees, downstream guarantees or cross stream guarantee?
        iv. Corporate structure, which entity in the corporate structure is doing the borrowing?
        v. Are there subordination agreements?
        vi. Is the credit instrument senior indebtedness or junior indebtedness?
        vii. Are security interests properly perfected?
        viii. What is the collateral quality?
        ix. Is there relief of stay litigation?
3. Reading debenture indentures
        i. Who is the trustee?
        ii. Who holds large chunks of the public debentures?
        iii. Do they have potentially blocking positions?
        iv. Any guarantees?
        v. How is a particular instrument likely to be classified in a POR?
4. How to read a Credit Agreement and an Indenture
    a. Similarities in these two document structures
    b. Differences in their structure
5. Case #1: Reading JC Penney 1994 Indenture.

V. FINANCIAL DISTRESS

1. *The road to financial distress.*
    a. Causes of financial distress and their implications for restructurings.
        i. Indicators of financial distress.
        ii. Lack of access to capital markets.
        iii. Deterioration of operating performance.
        iv. Deterioration of GAAP performance.
        v. Unexpected liabilities.

2. *Options for reducing/eliminating financial distress: The Company.*
    a. Strategic options.
        i. Asset sales.
        ii. Secured financings.
        iii. Sale/leaseback financings.
        iv. Equity infusions.

    b. Reducing leverage.

        i. Open market repurchases.
        ii. Direct purchases.
        iii. Cash tender offers.
        iv. Exchange offers.

    c. Factors affecting the range of options.
        i. Liquidity
        ii. Time-to-liquidity.
        iii. Magnitude of the problem.
        iv. Complexity of the capital structure.
        v. Causes of financial distress.

3. *Out of court restructurings*
    a. Professional fees in bankruptcy and when out of court restructurings have a chance of succeeding.
    b. Exchange offers.
    c. Prepackaged / Pre-negotiated bankruptcies.

VI. THE FIVE TRUTHS OF DISTRESS INVESTING *(Chapter 6 Distress Investing)*

1. Truth 1: No one can take away a corporate creditor's right to a money payment outside of a Chapter 11 or Chapter 7
2. Truth 2: Chapter 11 rules influence all reorganizations
3. Truth 3: Substantive Characteristics of Securities
4. Truth 4: Restructurings are costly for creditors
5. Truth 5: Creditors have only contractual rights

VII. THE BANKRUPTCY CODE (*A Short Course in Bankruptcy Law, and Chapters 7, 8, and 9 of Distress Investing)*

1. *Liquidations and Reorganizations*
    a. Making the difference between Chapter 7 and Chapter 11.
    b. What does liquidation mean?
    c. What does reorganization mean?
    d. Why bankruptcy?
2. *How to start a case*
    a. Involuntary filings (caveats)
    b. Voluntary filings
    c. Forum shopping
3. *What does filing for Chapter 11 get the company?*
    a. Automatic stay
    b. Exclusive right to propose a reorganization plan.
    c. Relief from having to pay for interest on unsecured claims (spontaneous financing).
4. *Who are the players*?

   a. The Debtor (the company)
   b. Judge
   c. Trustee
   d. Official committee of unsecured creditors
   e. Shareholders
   f. Management
   g. Attorneys
   h. Financial Advisers
5. *The bankruptcy code deals with claims and interests, NOT creditors and security holders.*
   a. The definition of a claim
   b. Secured and unsecured claims
   c. Who are likely to have secured and unsecured claims?
6. *Adequate protection*
   a. What it means for secured claims?
7. *Subordination agreements*
   a. They survive in bankruptcy because they are inter-creditor agreements
8. *Priorities*
   a. Section 507 and administrative priorities
   b. Rule of absolute priority
9. *Executory contracts and unexpired leases*
   a. The decisions to:
      i. Assume
      ii. Assume and assign
      iii. Reject
   b. Unexpired leases as a special executory contract.
10. *Disclosures to Security Holders*
   a. Disclosure Statement (equivalent to a prospectus)
   b. Court must approve
11. *Plan of Reorganization – contents*
   a. Designate claims or interests
   b. Impaired or unimpaired
   c. Treatment of different classes
   d. Adequate means of implementation
12. *Acceptance of a plan*
   a. Voting majorities
   b. Controlling position
   c. Blocking position
13. *Confirmation of a plan*
   a. Feasibility test
   b. Best interest test
   c. Cram-down of dissenting classes
14. *Expediting Bankruptcies*
   a. Administrative expenses
   b. Shortening the length of Chapter 11 proceedings.

VIII. INFORMATION

1. *Sources of Company information.* ***Class notes***
    a. SEC filings.
        i. 10-K Forms, Annual Reports.
        ii. 10-Q Forms, Quarterly Reports.
        iii. 8-K Forms, Current Reports.
        iv. Annual-meeting proxy statements (DEF-14).
        v. Offering Registration Statements (Forms S-#)
        vi. Disclosure document
        vii. Plan of reorganization
        viii. Loan Agreements
        ix. Indentures

    b. Reading a 10K
        i. The different parts of a 10K report.
        ii. What to find and how to find it on a 10K report.
        iii. The importance of Item 7: Management's discussion and analysis of financial condition and results from operations.
            1. Reading for changes in Item 7.
            2. Understanding the importance of Critical and Significant accounting policies and estimates.
            3. Expense and capitalization policies.
            4. Changes in Asset life / depreciation / residual values.
            5. Expense classifications.
            6. Changes in revenue recognition.
            7. Liquidity and capital resources.
            8. Off-balance sheet arrangements.
        iv. A gold mine of information in 10K reports: Notes to the financial statements.
        v. JC Penney 10K Case #2

2. *Sources of bankruptcy information*

    a. Once a company files information will be found from:
        i. Court documents (www.Pacer.gov)
        ii. Company press releases

V. VALUATION OF THE ESTATE

1. *Corporate valuation.*
    a. Corporate Valuation: the *going-concern* and *resource conversion* views of a corporation.

    b. **Strict going-concern** valuation approaches.
        i. The basics of cash flow or operating earnings based valuation.

ii. Using EBITDA as a measure of earnings from operations.
    1. Understanding and adjusting EBITDA
    2. Limitations of EBITDA
iii. Comparing discounted cash flow and EBITDA multiple approaches and how these two converge.
    1. Developing a quick DCF based valuation
    2. Incorporating expected growth into the valuation
    3. Incorporating leverage into the valuation framework
iv. Calculating enterprise value.
    1. Determining the correct multiple based on our valuation multiple.
    2. Using comparable company analysis.
        a. Finding comparables.
        b. Publicly Traded Comparables.
        c. Deal-Based Comparables.
        d. Examples.
    3. JC Penney going concern valuation exercise. Case #3

c. **Resource-conversion** type approaches to valuation.
    i. Asset-based valuations.
    ii. Liquidation valuations.
    iii. LBO valuation (recapitalization and changes in control).
    iv. Book value vs. Net Asset Value (NAV).
    v. Summary
d. JC Penney Resource Conversion Valuation Case #4

POLICY ON ACADEMIC INTEGRITY

Syracuse University has adopted an academic policy emphasizing that honesty, integrity, and respect for others are fundamental expectations. The Whitman School of Management requires all students who take Whitman courses to certify in writing that they have read, understood, and agreed to comply with the University's Academic Integrity Policy. The policy is available at http://academicintegrity.syr.edu Whitman students should have already completed a certification statement. All other students enrolled in this course are also required to complete a certification statement available in the Undergraduate Office (Suite 215). Completed statements will be kept on file in the Undergraduate or Graduate Office. Plagiarism and academic dishonesty are serious offenses. University policy dictates that any acts of academic dishonesty will lead to a grade of F for the course, accompanied by a note in your transcript of "Violation of the Academic Integrity Policy". For graduate students, acts of academic dishonesty will also lead to expulsion from the program and the university. Academic dishonesty includes team-based assignments where individual team members behave dishonestly. Turn-it-in software may be used for some assignments.

ACCOMMODATIONS FOR DISABLED STUDENTS

Syracuse University and I are committed to your success and to supporting Section 504 of the Rehabilitation Act of 1973. This means that in general no individual who is otherwise qualified shall be excluded from participation in, be denied benefits of, or be subjected to discrimination under any program or activity, solely by reason of having a disability.

If you believe that you need accommodations for a disability, please contact the Office of Disability Services (ODS), http://disabilityservices.syr.edu, located in Room 309 of 804 University Avenue, or call (315) 443-4498 for an appointment to discuss your needs and the process for requesting accommodations. ODS is responsible for coordinating disability-related accommodations and will issue students with documented disabilities Accommodation Authorization Letters, as appropriate. Since accommodations may require early planning and generally are not provided retroactively, please contact ODS as soon as possible.

<u>You are also welcome to contact me privately</u> (as early as possible) to discuss your academic needs, although I cannot arrange for disability-related accommodations.

The University's Statement can be accessed at:

http://universitysenate.syr.edu/curricula/disability-syllabus-statement.html