

**NEW YORK UNIVERSITY - LEONARD N. STERN SCHOOL OF BUSINESS**

B40.3176.32

**Topics in Investments: Investing in Distressed Securities**

Spring 2009

Wednesdays 6:00 – 9:00 pm (February 11 – March 25; no class on March 18)

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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, 3<sup>rd</sup> Edition  
Edward I. Altman and Edith Hotchkiss (Wiley, 2005)
- 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)
- Bankruptcy Code, Rules, and Official Forms; 2007 Law School Edition  
(Thompson West, 2007)
- A good online site to reference the code is: [law.cornell.edu/topics/bankruptcy.html](http://law.cornell.edu/topics/bankruptcy.html)
- Other materials and case studies will be distributed in class

**Other texts and sources of information**

**Periodicals**

- *Bond Investors Association: Troubled Company Reports (various)*
- *Daily Bankruptcy Review*
- *The Daily Deal*([www.thedeal.com](http://www.thedeal.com))

## Topics in Investments: Investing in Distressed Securities

**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:** 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. 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).

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 statements 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)
  - Recommendation (One short sentence telling me what the conclusion is); puts the entire paper in context as I go through it
  - Text of recommendation
    - Rationale supported by data, evidence, exhibits
    - Risks
    - Expected IRRs, risks, 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.**

<b>Grading:</b>	Case summaries	100%
	Class participation*	$\frac{+/-}{100\% (+/-)}$

# Topics in Investments: Investing in Distressed Securities

## 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><b>BRAD SCHELER – TOPIC TBD</b>  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  <i>Case 2 discussion</i>  <i>Case 3 distributed: Evaluation of a Plan of Reorganization and Disclosure Statement</i></p>
5	<p><b>BRAD SCHELER – TOPIC TBD</b>  The Bankruptcy Code in more detail; implications for investors  Equitable subordination  Substantive consolidation  Recharaterization  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  <b>GUEST LECTURER – to be announced</b></p>
6	<p><b>BRAD SCHELER – TOPIC TBD</b>  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></p>