

The Wharton School – University of Pennsylvania
FNCE 753
Distressed Investing and Value Creation

Fall 2021

Preliminary Course Syllabus

(Please note that this syllabus is subject to change over the duration of the course; however, the general structure and content of the course will remain the same.)

Professor Kevin Kaiser

Teaching Assistants

Kshitiz Garg (kshitizg@wharton.upenn.edu)
Kanishka Ragula (kragula@wharton.upenn.edu)
Amine Soufaih (asoufaih@wharton.upenn.edu)

Classroom: JMHH 350

FNCE 753: M/W 10:15 a.m. – 11:45 a.m.

Course Description

This course is designed to provide students with an understanding of the issues regarding distressed investing and valuation. Due to the very challenging nature of distressed situations, many angles are relevant to assessing an investment opportunity including:

- Ability to assess the business performance and prospects for the company – why is it in distress and does it have a future?
- An understanding of the interplay between the ‘left hand side’ of the balance sheet (the business) and the ‘right hand side’ of the balance sheet (the capital structure) – how has the capital structure helped/hurt the business and *vice versa*?
- Understanding the financial and business restructuring possibilities and likelihoods for turning around the business and facilitating operating improvement – what will it take to turn this business around and is it likely to happen under current ownership/management?
- Being able to estimate the resulting value of the business (‘size of the pie’) and the allocation of value across the capital structure (‘how the pie will be split’) – valuation skills are of critical importance in any investing effort, but in distress situations there are many complications which challenge even the most seasoned valuations expert. We will spend considerable time on this and the role of finance (theory and practice) in helping us to understand how to estimate the size of the pie
- The legal environment – understanding the size of the pie is only the first step. We must also be able to understand how the pie gets split across the capital structure. This will require knowledge of the legal position of each investor, which will include an understanding of the credit agreements, inter-creditor agreements and how an in-court restructuring (in Chapter 11, in the USA) will treat the various creditors.

By the end of the course participants should

- be familiar with the game theory essentials of a distressed restructuring
- be familiar with the various parties, and their roles and interests, in a typical restructuring
- be comfortable forecasting cash sources and uses to assess the extent of the crisis, the likelihood of recover, the debt repayment capacity, and understand, from an investing point of view, how to identify the fulcrum security and be able to assess the recovery potential of the different levels of the capital structure
- have a deep understanding of the principles of finance and valuation and how these enhance and enable the investor to better understand the size of the pie
- be familiar with the legal environment which frames distressed restructurings in the USA and how this impacts how the pie will be split among creditors
- have insights into the different legal and negotiating alternatives for resolving differences in interests across parties to facilitate deal conclusion
- be familiar with the tools and methods for anticipating the financial distress of an organization and understand why the firm is in financial distress
- be able to assess the extent to which alternative restructuring proposals will succeed or fail to enable correction of the management errors which led to the distress in the first place
- understand how to assess both the sources and magnitude of the value creation (or destruction) potential of a restructuring event as well as the various transfers of value across parties to the restructuring.

The course will comprise three phases: lectures, case discussions, and student-driven learning (interactive and/or research projects and personal reflection).

1. The first phase of the course will be lecture classes and guest speakers. These will focus on establishing the legal framework, including the fundamental rights and obligations of debtors, creditors, and other parties in interest in the various types of major chapter 11 cases, and the conceptual framework for assessing a firm's financial viability and the causes of financial distress and the value impact of alternative restructurings. This foundation will provide critical insight into understanding the motivations, strategies, and available tools for chapter 11 participants. We will also review and deepen valuation skills, forecasting skills, Excel model-building skills, and ability to assess investment opportunities and model these opportunities in Excel to distinguish the value of the opportunity from the price in order to assess its worthiness as an investment.
2. The second phase of the course will feature a series of case exercises, and classroom discussions and reflection. The case exercises are intended to provide participants an opportunity to work in teams and discuss, analyze, and propose their recommendations for resolving the case situation.
 - The Bayfield case (waterfall exercise) is to be completed by each participant **individually**. You may discuss your work with other members of your team, but you must submit your Excel files individually for grading and credit.
 - The Trump Entertainment Resorts (TER) (negotiation exercise) is to be completed in teams. This exercise will require multiple submissions of both reports (**in pdf format**) and Excel spreadsheets. Grading will be team-based.
 - Each team must submit a report – maximum of 3 pages text plus exhibits (**in pdf format**) – exhibits may also be submitted in Excel format.

Some of the case assignments contain questions that need to be addressed, however you will also

be graded based upon how well you identify the relevant questions and issues to be addressed. Therefore, whether there are questions for the case or not, please consider (1) what the relevant questions are in the context of each case and (2) why these questions are relevant (or not), and then (3) perform the necessary analysis to address these questions.

3. The third phase of the course will involve student-driven learning, including the TER negotiation case simulation, in which students will be assigned participant roles and challenged to apply the lessons to navigate their way through a distressed negotiation exercise. There will also be a group-based research project - participants will be expected to research a particular case/topic/event related to corporate restructuring and submit a 5-10-page report and prepare a presentation to the class on the topic/event. Finally, each participant (individually) must submit a summary of her/his personal reflections on their key learnings from the course.

Grades will be based upon individual and team performance assessed as follows:

1. PARTICIPATION: Individual (15% of final grade)
2. WATERFALL EXERCISE (Bayfield): Individual (15% of final grade)
3. NEGOTIATION EXERCISE (TER): Group (20% of final grade, group grade allocated across group members based upon group member self-allocation)
4. CASE EXERCISES: Group; Long reports for the remaining 3 case exercises (25% of final grade, group grade allocated across group members based upon group member self-allocation)
5. TOPICAL GROUP RESEARCH PAPER: Group; A research paper on a self-selected topical issue/event related to distressed restructuring to be presented to the class (20% of final grade, group grade allocated across group members based upon group member self-allocation)
6. INDIVIDUAL REFLECTION PAPER (5% of final grade) Learning is an effortful process and I have added this assignment in place of a final exam. The purpose of this exercise is to ensure that each individual devotes some time to reflecting back on this course and trying to recall and deepen your understanding of the many topics and concepts covered. It is intended as a 'learning' element, rather than as a 'grading' element. You are expected to submit your individual reflections on what you learned during this course and the insights you gained. It is expected to be between 2-5 pages and address the following elements: (1) Summarize and demonstrate understanding of the concepts taught in this course, (2) Summarize the insights you gained, and (3) Describe how these insights will impact you/your behavior going forward. Please do not be evaluative (e.g., please avoid statements such as "I really loved the session when we talked about..." or "I found the discussion around xxx to be very confusing...") Simply emphasize your learning by structuring your reflections as, "What I learned was" Grading will be based on the depth and quality of your reflections as reflected in the depth and quality of the learning and insights you share in this report.

Note: all written work must be submitted via Canvas in either Excel format (for all spreadsheet submissions) or PDF format (for all written reports) and the filename must indicate the individual's name or team number (for group assignments include both team number and names of team members) and title of the assignment. For the Case Exercises, please ensure your submission also indicates (in the filename of the pdf document) whether it is the "long" report or the "short" report in addition to the name of the case.

Important Note Concerning Group Grading Process:

To provide effective governance and to encourage effective teamwork, grades for groupwork will be allocated according to contribution allocations as assessed by the other members of your group for ALL group members of ALL groups. All group members are required to provide a response to the survey question below after all group work for the course has been completed. The results will apply to group grade allocation across group members for ALL of the groupwork throughout the course,

Survey question to be answered by all students enrolled in the course:

Please provide an allocation out of 100% for the contribution made by the individual members of your group to all group work submitted in this course, excluding any measure of your own contribution, such that the sum totals 100%.

Each group member's contribution will be assessed as the average of the percentages reported by the other members of the group. For example, if you are in a 5-member group and the other four members of your group gave you contribution allocations of 20%, 20%, 25% and 15%, then your average is 20% across 4 people, which translates into 16% across 5 (which puts you below average).

See the chart below as a sample template:

Group member name:	Howard Marks	Marie Curie	Mary O'Connor	Martin Luther King, Jr	Michael Jordan	Allocation (out of 25%)	Percent allocation (out of 20%)
Howard Marks		20%	20%	15%	25%	20%	16%
Marie Curie	25%		25%	25%	25%	25%	20%
Mary O'Connor	35%	30%		35%	30%	33%	26%
Martin Luther King, Jr.	35%	30%	35%		20%	30%	24%
Michael Jordan	5%	20%	20%	25%		18%	14%
TOTAL	100%	100%	100%	100%	100%	125%	100%

Your own grade will be the average of the contribution allocated by you as reported by your teammates. For example, if your 4 teammates gave you contribution allocations of 20%, 20%, 15% and 25%, such as for Howard Marks above, then your average allocation would be 20% as assessed by your 4 teammates, which results in a relative contribution of 16% out of 20% for your contribution to the team. In this case, your team grade will be reduced by 4% of the team average grade. As another example, had your teammates given you contribution allocations of 25%, 25%, 25%, and 25%, such as for Marie Curie above, then your average allocation would be 25%, which results in a relative contribution of 20% out of 20%.

Your resulting relative contribution allocation as rated by your teammates will then be used to either add to or deduct from the team's overall grade on the group assignments according to the distance your relative contribution allocation is away from 20% (for groups of 5) or 25% (for groups of 4). Each 1% above/below the mean will result in an addition/deduction of 1% of the group grade. Therefore, for example if your group grade is 18/20 on the TER Negotiation exercise and your relative contribution is rated 24% in a team of 5, such as for Martin Luthor King, Jr. above, so that you are 4% above the mean of 20% for relative contribution, then your grade on the TER Negotiation exercise will be $104\% \times 18 = 18.72/20$. As another example, if you are in the same group with a group grade of 18/20 but your relative contribution is rated 14% in a team of 5, then your grade will be $94\% \times 18 = 16.92/20$.

Draft Course Schedule (subject to change to accommodate speaker's agendas)

753 Fall 2021: JMHH 350, 10:15am-11:45am			
Class #	Date	Topic	Assignment
1	Monday, August 30, 2021	Course Introduction	no assignment due today
2	Wednesday, September 1, 2021	Games and setting the stage	no assignment due today
	Monday, September 6, 2021	LABOR DAY - No class	No class
3	Wednesday, September 8, 2021	Conceptual foundation - Valuation in Distress	no assignment due today
4	Monday, September 13, 2021	Intro to the Waterfall - Valuing the Business	no assignment due today
5	Wednesday, September 15, 2021	Financial Analysis & Valuation Principles	BG - 1 - Financial analysis & liquidity
6	Monday, September 20, 2021	Forecasting Cash Generation & Valuation	BG - 2 - Forecasted cash flow & valuation
7	Wednesday, September 22, 2021	Continuing value and discount rates	BG - 3 - Continuing value & Discount Rates
8	Monday, September 27, 2021	Debt capacity & Leverage	BG - 4 - Debt Capacity/Repayment and "Waterfall"
9	Wednesday, September 29, 2021	Recap and wrap-up Valuation Elements	no assignment due today
10	Monday, October 4, 2021	Distress Investment/Negotiation Exercise	TER setup discussed today
11	Wednesday, October 6, 2021	Distress Investment/Negotiation Exercise	TER Negotiation
12	Monday, October 11, 2021	Distress Investment/Negotiation Exercise	TER debrief
	Wednesday, October 13, 2021		
	Monday, October 18, 2021		
	Wednesday, October 20, 2021		
13	Monday, October 25, 2021	Speaker (Advisors - Investment Banks)	Soren Reynertson confirmed - Detroit case
14	Wednesday, October 27, 2021	Speaker (Advisors - Legal)	Andy Goldman - and Bao Truong confirmed
15	Monday, November 1, 2021	Speaker (Investor)	Alp Ercil or Howard Marks?
16	Wednesday, November 3, 2021	Speaker (Investor)	Michael Weinstock - 10:30 only (now noon only?) - confirm
17	Monday, November 8, 2021	Speaker (Turnaround Management)	Turnaround Mgmt - Doug Rosefsky?
18	Wednesday, November 10, 2021	Speaker (Turnaround Management)	Rossignol/Crisis at the Mill - Doug Rosefsky?
19	Monday, November 15, 2021	Dealing with Chapter 11	Joint Sessions: (1) Hertz & (2) Chrysler 363 Sale to Fiat
20	Wednesday, November 17, 2021	Debrief Thomas Lauria	Hertz & Chrysler
	Monday, November 22, 2021		
	Wednesday, November 24, 2021	THANKSGIVING - no class	No class
21	Monday, November 29, 2021	Presentations & Reflection	Group presentations
22	Wednesday, December 1, 2021	Presentations & Reflection	Group presentations
23	Monday, December 6, 2021	Presentations & Reflection	Group presentations
24	Wednesday, December 8, 2021	Presentations & Course wrap-up	Group presentations

List of Readings (Canvas may contain additional readings)

- Chapter 16, “Financial Distress,” from *Corporate Finance*, 4th edition, by Berk and DeMarzo, 2016
- The Costs of Financial Distress, by Kevin Kaiser, lecture note
- Eckbo, B. Espen and Li, Kai and Wang, Wei, “Rent Extraction by Super-Priority Lenders”, (December 18, 2020). Tuck School of Business Working Paper No. 3384389 (2019), Available at SSRN: <https://ssrn.com/abstract=3384389> or <http://dx.doi.org/10.2139/ssrn.3384389>
- Casey, Anthony J, and Joshua C. Macey, “The Hertz Maneuver (and the Limits of Bankruptcy Law)”, *The University of Chicago Law Review Online*, 10/07/2020.
- “The Expected Costs of Distress,” Glover, *Journal of Financial Economics*, 119 (2016), 284-299.
- “The Ownership and Trading of Debt Claims in Chapter 11 Restructurings,” Ivashina, Iverson and Smith, , *Journal of Financial Economics*, 119 (2016), 316-335.
- Buccola, Vincent S.J. and Mah, Jameson K. and Zhang, Tai Yi, The Myth of Creditor Sabotage (October 8, 2019). 87 *University of Chicago Law Review* 2029 (2020)
- “A Market-based Study of the Cost of Default,” Davydenko, Strebulaev, and Zhao, *The Review of Financial Studies*, Volume 25, Issue 10, October 2012, Pages 2959–2999,
- “How Costly is Financial (not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed,” Andrade and Kaplan, *Journal of Finance*, October 1998, 1443-1493
- “Coming Through in a Crisis: How Chapter 11 and the Debt Restructuring Industry Are Helping to Revive the US Economy,” Stuart Gilson, *Journal of Applied Corporate Finance*, Fall 2012
- “Managing for Value 2.0,” by Kaiser and Young, *Journal of Applied Corporate Finance*, Winter 2014
- “The Hazards of Growth,” by Kaiser and Young, *Journal of Applied Corporate Finance*, Summer 2015
- Chapters 3 & 4, from *The Blue Line Imperative*, by Kaiser and Young, 2013
- *Distressed Debt Analysis: Strategies for Speculative Investors*, by Stephen G. Moyer, 2005
- Schoenberg, R.; Collier, N.; Bowman, C. Strategies for business turnaround and recovery: a 396 review and synthesis. *European Business Review* **2013**, 25, 243-262
- Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 *YALE L. J.* 648 (2009-2010)
- James H.M. Sprayregen, *et al.*, *Chapter 11: Not Perfect, But Better than the Alternatives*, 14 *J. BANKR. L. & PRAC.* 6 (Dec. 2005)
- Statement of James H.M. Sprayregen to the ABI Commission for the Reform of the Chapter 11 of the Bankruptcy Code
- Mike Spector & Tom McGinty, *Bankruptcy Court is Latest Battleground for Traders*, *WALL ST. J.* (Sept. 7, 2010), *available at* <http://online.wsj.com/article/SB10001424052748703309704575413643530508422.html>
- James H.M. Sprayregen, *et al.*, *The Race to the Starting line: Developing Prepackaged and Prenegotiated Reorganization Plans to Maximize Value*, in *Navigating Today’s Environment*, The

Directors' and Officers' Guide to Restructuring (2010)

- Brian K. Tester, *et al.*, *Need for Speed: Prepackaged and Prenegotiated Bankruptcy Plans* (American Bankruptcy Institute), available at <http://www.abiworld.org/committees/newsletters/busreorg/vol9num7/pack.pdf>
- Managing Financial Distress, by Kevin Kaiser, lecture note
- Chapter 5, “Distressed Firm Valuation,” from *Corporate Financial Distress and Bankruptcy*, 3rd edition, by Altman and Hotchkiss, 2006
- Hon. Christopher S. Sontchi, *Valuation Methodologies: A Judge’s View*, 20 AM. BANKR. INST. L. REV. 1 (Spring 2012)
- Chapter 10, Profiting from Financial Distress: The Investor’s Perspective, from *Distressed Debt Analysis: Strategies for Speculative Investors*, by Stephen G. Moyer, 2005
- Caesars Entertainment Corporation, Columbia Business School case CU65
- Chapter 11, Corporate Credit Scoring – Insolvency Risk Models, from *Corporate Financial Distress and Bankruptcy*, 3rd edition, by Altman and Hotchkiss, 2006
- Modelling Default Risk, KMV
- Predicting a Firm’s Financial Distress – Merrill Lynch, Ivey case W12114
- Chapter 11, Corporate Credit Scoring – Insolvency Risk Models, from *Corporate Financial Distress and Bankruptcy*, 3rd edition, by Altman and Hotchkiss, 2006
- Modelling Default Risk, KMV
- Predicting a Firm’s Financial Distress – Merrill Lynch, Ivey case W12114
- Dealing with Distress – Paramount Equipment, HBS case 9-914-557
- Hon. Christopher S. Sontchi, *Valuation Methodologies: A Judge’s View*, 20 AM. BANKR. INST. L. REV. 1 (Spring 2012)
- Chapter 8, Causes of Financial Distress and the Restructuring Implications, from *Distressed Debt Analysis: Strategies for Speculative Investors*, by Stephen G. Moyer, 2005
- Pinewood Mobile Homes, HBS case 9-915-547
- The Energy Patch: Where Rights Offerings are ‘Sexy’ Again, Reuters, Aug. 1, 2017 (<https://www.reuters.com/article/us-usa-bankruptcy-offerings/the-energy-patch-where-rights-offerings-are-sexy-again-idUSKBN1AH408>)
- Rights Offerings in Bankruptcy: More than New Capital, *Journal of the Association of Insolvency and Restructuring Advisors*, Dec/Jan 2011
- “A Primer on Distressed Investing: Buying Companies by Acquiring Their Debt,” Stephen G. Moyer, David Martin, and John Martin, *Journal of Applied Corporate Finance*, Fall 2012
- Citigroup Exchange Offer, HBS case, 9-210-009
- Chapter 9, Options for Alleviating Financial Distress: The Company’s Perspective, from *Distressed Debt Analysis: Strategies for Speculative Investors*, by Stephen G. Moyer, 2005
- Crisis at the Mill, INSEAD case study, IN1030
- Chapter 12, Dynamics of the Workout Process: The Endgame, from *Distressed Debt Analysis:*

Strategies for Speculative Investors, by Stephen G. Moyer, 2005

- Chrysler's Sale to Fiat, HBS case 9-210-022
- Chapter 10, Profiting from Financial Distress: The Investor's Perspective, from *Distressed Debt Analysis: Strategies for Speculative Investors*, by Stephen G. Moyer, 2005