From Feast to Famine and Back Again: Credit Markets over the Past Decade

(** Tentative spring 2016 syllabus: All information below is subject to change**)  

PROFESSORS
Ellen Carr
Office Hours: By Appointment

REQUIRED COURSE MATERIAL

Your reading assignment is one book, a selection of memos from Howard Marks, and a selection of articles on the credit crisis and behavioral finance; the second book is for reference.


3/07 Race to the Bottom
7/07 Its All Good
9/07 Now its all Bad
9/08 Nobody Knows
10/08 Limits to Negativism

Please read the following articles (available on the Canvas website):

http://www.newyorker.com/tech/frontal-cortex/why-smart-people-are-stupid
http://www.ft.com/cms/s/0/80e2987a-2e50-11dc-821c-0000779779d2ac.html#axzz3Ee1EYFvb
http://www.newyorker.com/magazine/2009/09/21/eight-days

For reference, you may want to buy "Investment Banking: Valuation, Leveraged Buy-Outs and Merger & Acquisitions," J. Rosenbaum and J. Pearl, John Wiley & Sons, New York, 2009, 247 pp. This is a practitioner’s book which is a review of fundamentals of corporate finance and capital markets.

REQUIRED PREREQUISITES AND CONNECTION TO THE CORE

The learning in this course will utilize, build on and extend concepts covered in the following core courses:
Students will be expected to have mastered these concepts and be able to apply them in the course.

<table>
<thead>
<tr>
<th>Core Course</th>
<th>Connection with Core</th>
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</thead>
<tbody>
<tr>
<td>Corporate Finance</td>
<td>1. Opportunity cost of capital</td>
</tr>
<tr>
<td></td>
<td>2. Risk</td>
</tr>
<tr>
<td></td>
<td>3. Firm valuation model</td>
</tr>
<tr>
<td>Global Economic Environment</td>
<td>1. Causes of business cycle</td>
</tr>
<tr>
<td></td>
<td>2. Role of financial markets in the economy</td>
</tr>
<tr>
<td>Decision Models</td>
<td>1. Sensitivity Analysis</td>
</tr>
<tr>
<td></td>
<td>2. Decision making under uncertainty and risk</td>
</tr>
<tr>
<td></td>
<td>3. Use of analysis in decision making</td>
</tr>
<tr>
<td>Financial Accounting</td>
<td>1. The accounting model</td>
</tr>
<tr>
<td></td>
<td>2. Revenue and expense recognition</td>
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<td></td>
<td>3. Resources and obligations—measurement and disclosure</td>
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COURSE DESCRIPTION

In this course, we discuss the evolution of the bond and loan markets, and the behavior of market participants from peak to trough and back again in the past decade.

COURSE OBJECTIVES

Through lectures, cases and guest speakers, we discuss through-cycle changes in valuation, structure, capital raising, liquidity and other investor considerations.

ASSIGNMENTS

Please note that you have a pre-class assignment which must be submitted via Canvas by 5pm on Friday, January 9th. Your first assignment is to write a brief (no more than two pages) summary of the major points raised in the course readings that deal with concepts of behavioral finance and the cyclicality of investor psychology. You might wish to address the following questions in your write-up:

- Compare the perspectives (bull and bear cases) of Chuck Prince in 2007 and the bank CEOs in the “Eight Days” article in 2008. Was either perspective too bullish/bearish? How can investors make money from the volatility in sentiment observed during this short peak-trough timeframe?
- Describe a situation in which you found yourself the victim of cognitive bias.
- Are the tenets of efficient markets and behavioral finance contradictory/mutually exclusive? Why or why not? How do they work together/at odds with one another?

For team casework and the final project, form teams of three to five. Take advantage of your classmates’ different backgrounds, experiences and interests. The questions for the cases and the final project can be found below. Note that we will also do a fourth case, Realogy, which will not have an accompanying written assignment but will require discussion in your teams to prepare for an in-class case debrief.

Three Cases (Type A)
Please answer the questions below for the case part of the grade. We will select a few teams at random to present each case in class, with the goal being that each team will present in class once, so come prepared with a brief (2-4 page) Powerpoint presentation for each case.

HCA and Tomkins*

Please note that answers should never be more than one page.

1. What was the investment rationale for this transaction?
2. How does this investment rationale translate into a cash flow forecast?
3. Input this cash flow forecast into the short-form LBO model provided to you on day one of the course.

NXP

Make a case for either participating or not participating in the first exchange at the terms set forth in the case. In your analysis you might consider the following:

- Recovery values of the New Super Priority and existing secured and senior notes (current/trough, normalized, upside)
- The psychology of the high yield bond and leveraged loan markets at the time of the exchange (March 2009)
- The semiconductor cycle’s trajectory
- NXP’s liquidity position and the likelihood of a bankruptcy filing
- The improvement in NXP’s capital structure likely to result from a successful exchange
- Total return forecasts for each bond (senior unsecured, senior secured, New Super Priority 10% notes)

Group A: Teams 1-5

Make a case for participating in the first exchange at the terms set forth in the case.

Group B: Teams 6-10

Make a case for NOT participating in the first exchange at the terms set forth in the case.

Realogy (ungraded but will count towards class participation grade)

You will be assigned the Realogy case to discuss in class. There is no written assignment for this case, but come prepared to discuss the following questions.

1. With the benefit of hindsight, Apollo’s investment rationale and decision to “double down” on its investment by buying bonds makes sense. Identify two or three circumstances that were critical to its ability to make money on Realogy.

2. What was Apollo’s investment rationale for doing the IPO in 2012? How do you think the events leading up to the IPO (distress and near-impairment of Apollo’s equity position) contributed to the timing of the IPO?

Final Project*
For the final project, you will act as market practitioners and evaluate the securities in the capital structures of the three cases (HCA, NXP, and Realogy) to construct an optimal high yield credit portfolio (Tomkins does not have any public securities outstanding at this time). You are also permitted to include cash and the high yield index as investments in your optimal portfolio. You should use the following questions to frame your analysis.

• Which security/investment is the best risk-reward in each capital structure?

• Which security/investment offers the most upside potential in each capital structure?

• What operational/industry considerations went into your analysis? (Sample answer: “Semiconductor manufacturers have more seasonal cyclicality and operating leverage than average, so I’m less comfortable with the most subordinated parts of their capital structures.”)

• If you chose not to invest in one or more of the companies, why? What would make you comfortable investing in that company, and which part of the capital structure would you be most interested in?

• What are the biggest valuations discrepancies in current market pricing? (Sample answer: “NXP secured debt trades on top of HCA bank debt, but the collateral coverage at HCA is much better.”)

• How did you evaluate the attractiveness of these investments relative to the HY index and cash? If you chose to invest in either of the latter, why?

Extra credit: How does your portfolio’s yield, maturity, and average rating translate into a view of the high yield market? (Sample answer: “My portfolio is lower-yielding and higher-rated than the high yield index, and includes some bank debt, so I’m cautious about valuations today.”)

*Asterisk denotes assignment is Type A described in the chart below
In order to avoid ambiguity that may lead to unintentional violations of the Honor Code, the description types for assignments have been standardized. They are specified in the table below.
<table>
<thead>
<tr>
<th>Type</th>
<th>Designation</th>
<th>Discussion of concepts</th>
<th>Preparation of submission</th>
<th>Grade</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>group / group</td>
<td>Permitted with designated group*</td>
<td>By the group</td>
<td>Same grade for each member of the group</td>
</tr>
<tr>
<td>B</td>
<td>group / individual</td>
<td>Permitted</td>
<td>Individually</td>
<td>Individual</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>(No sharing of any portion of the submission)</td>
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</tr>
<tr>
<td>C</td>
<td>individual / individual</td>
<td>None of any kind</td>
<td>Individually</td>
<td>Individual</td>
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<tr>
<td>D</td>
<td></td>
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<td>(An optional category to be defined in detail by the individual faculty member)</td>
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The designated group can be either an assigned study group or a self-selected one.

**METHOD OF EVALUATION**

Final grades will be based on the breakdown below.

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<table>
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<tr>
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<tbody>
<tr>
<td>Pre-class write-up</td>
<td>10%</td>
</tr>
<tr>
<td>Participation</td>
<td>20%</td>
</tr>
<tr>
<td>3 Cases</td>
<td>45%</td>
</tr>
<tr>
<td>Team Final</td>
<td>25%</td>
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</tbody>
</table>

Attendance, the quality of your class participation, and evidence of your extracurricular interest in the topic (e.g. evidence of outside reading, discussion of recent transactions) will form the basis for your class participation grade. **This is a highly interactive class and your participation is critical to your success and the success of the course.** You should not take the course unless you recognize the need for participation. There will be substantial cold calling.

**CLASSROOM NORMS AND EXPECTATIONS**

In-class, please demonstrate consideration for your classmates (and your instructors and guest speakers) by closing laptops, posting nameplates, and being on time at the beginning of the class and at break. To ensure that we get to know you quickly, please sit in the same place in each class.

Cases, readings and related materials will be made available via Canvas.

Slide presentations will be available on Canvas.

Use Canvas for all casework and for the final project; submit casework by the start of class each day (9am).

The final project is due by 5pm on the Monday the week after the class.