Columbia Business School

**Professor Michael Grad**
**Spring 2020**

# Corporate Finance, Restructurings & LBOs

## Who is this Course Intended for?

This course is intended for students who wish to learn about corporate capital structure, debt restructuring and bankruptcy, M&A and LBOs from the viewpoint of the large corporation. This course will be useful for investment bankers, bankers, finance professionals in corporations (CFO and treasury departments) and specific types of investors (distressed and bankruptcy investors, risk arbitrageurs, event driven investors). This is not a course in general investing or valuing securities. Students must have knowledge of introductory finance and financial accounting.

## Synopsis

Corporate finance entails how corporations design and issue securities and create a capital structure (debt and equity) to most effectively raise capital from investors and lenders to finance their operations. The course will cover (i) a detailed overview of corporate capital structures, (ii) bankruptcy and debt restructuring as the best example of the importance of hierarchy/priority in capital structure, and (iii) how corporations transform their capital structure through M&A or leveraged buyout (LBO) transactions. This course will combine theory and actual examples from Wall Street transactions and from the world of investment banking and private equity. The course will also discuss how the capital markets and these transactions have evolved over time.

## Capital Structure

The left side of a balance sheet (assets) represents what a corporation has that is of value; the right side (liabilities and equity) represents how claims against that value are allocated. As you move down the right side of the balance sheet (from short term debt to long term bank debt to bonds to preferred stock to common stock), you move from lower risk and return and shorter duration to higher risk and return and longer term (or perpetual) financing. This section involves a detailed analysis of the liability side of actual corporate balance sheets (including reading selected parts of loan agreements, bond indentures, etc.). The key distinctions between various types of debt will be emphasized: bank vs. bond, fixed versus floating rate (and how priced, i.e., based on Libor or US Treasuries), secured vs. unsecured, senior vs. subordinated (discussion of contractual vs. structural subordination), covenants (maintenance vs. incurrence tests) and the role of rating agencies. We will discuss which types of debt a corporation chooses to issue under various market conditions. This will be followed by an introduction to convertible debt, hybrid debt, preferred stock and common stock. We will make the distinction between debt as a contractual obligation of the issuer and equity as a residual ownership interest whose interests are represented by the Board of Directors. To truly understand the relevance of debt hierarchy and these protections (such as collateral or seniority), one needs to understand bankruptcy and debt restructuring (when things go wrong) where these distinctions become vitally important. Conversely, to understand returns to creditors in a bankruptcy or debt restructuring, one must understand capital structure hierarchy.

**Bankruptcy and Debt Restructuring**

Basic description of bankruptcy process - Chapter 11 reorganization versus Chapter 7 liquidation. The negotiation among the parties in a Chapter 11 proceeding is guided by the strict priority rules of a Chapter 7 liquidation. Discussion of the priorities of various classes of debt in a bankruptcy. Outline of how a Chapter 11 proceeds, how the negotiation among the various constituent parties works (impaired versus unimpaired classes, the voting rules, confirmation, etc.). Out of court restructurings (the holdout problem) versus bankruptcy as well as the pre-packaged bankruptcy, which is a very effective hybrid of these two methods. Also a brief discussion of how to take control of a company in bankruptcy (by purchasing the senior impaired class). This unit will show the importance of capital structure hierarchy. Distributions and returns to creditors in a debt restructuring are vastly different based on the seniority and the other structural terms of the debt instruments which they hold. We will study real world examples including recent debt restructurings/bankruptcies such as GM, Chrysler, Tribune & CIT.

**Valuation**

We will contrast measures of earnings that are capital structure independent (EBITDA) vs. capital structure dependent (Net Income). Therefore, one uses EV/EBITDA or EBIT (as Enterprise Value is theoretically capital structure independent) or P/E (both stock price and Net Income are capital structure dependent). Discussion of the different methods of valuing a company (earnings multiples, discounted cash flow) using an M&A fairness opinion as an example. We will then discuss how leverage magnifies risk and return which is the underlying rationale behind an LBO.

**Common Stockholders and the Board of Directors**

Debt in all its various forms is a purely contractual obligation between the debtholders and the company. There is no fiduciary duty of directors to creditors outside of insolvency. Common stock as a residual interest in the value of the corporation has almost no contractual protections. The common stockholders depend on the Board of Directors' exercise of fiduciary duties to protect their interests. We will discuss what are Board of Director decisions vs. management decisions. We will study the decision-making process of Directors in the M&A and going private (LBO) context.

**M&A**

We will discuss the three mechanisms for acquisitions: statutory merger vs. stock purchase (tender offer) vs. asset purchase; friendly negotiated vs. unsolicited tender offers; rules regarding tender offers (Williams Act); appropriate defenses against tender offers; and Board of Directors decision-making in the context of merger/LBO transactions. Discussion of specific issues such as the right of a company to stay independent (just say no defense), obligation to auction the company, and directors decision making in the context of competing and/or management-led bids, which will lead into a discussion of the leveraged buyout.

**The Leveraged Buyout (going private) Transaction**

This unit will entail a discussion of LBO mechanics. We will analyze step-by-step how a management team would pursue an LBO (what are the key factors in deciding whether to go ahead, approaching equity and debt financing sources, formulating an offer, approaching the Board of Directors, etc.). We will then discuss the nature of the Board's decision whether to support a going private transaction (e.g., the inherent conflict between management and the Board, the independent committee, the fairness opinion, does the Board need to auction the company and the "market check"). We will also discuss financing (representative capital structures and the role of private equity).

**Course Materials**

The lectures and class discussions are essential. Class attendance is expected. Most course readings are in the case books. I have ordered 2 textbooks, but we will read only selected parts and a large portion of the assigned reading will come from other sources (particularly primary sources).

**Deliverables**

There will be one mid-term take-home written case assignment during the semester to be completed by students individually. There will also be a small group project during the semester. There will also be a take-home final exam also to be completed individually. Students will be graded on the written assignments and class participation.