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Proceedings of the Institute for Finance Case Research

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NETSCAPE (IPO): INITIAL PUBLIC OFFERING CASE

William H. Brent, Howard University

ABSTRACT

The following case represents the issue of public equity by an internet firm which, for all intents and purposes is the classic example of those internet search engine firms obtaining equity funding for growth and capitalization in today's profitable market. The case has pedagogical merit in presenting valuation and market entry determination of initial public offerings which have no historical clearing price or value foundation. Its historical use has been for MBA students concentrating in finance, international business and investment analysis. The significance of this IPO to finance markets and to students of the art is that it did not follow traditional trends of pre-issue or post-issue valuation but achieved nearly a one thousand percent value growth, and astonished both analysts and the firm's management also. The issue basically, began a process of restructuring and reshaping the financial investment and security management environment. Many members of the equity management and pension fund communities have offered much debate on the relative course of this issue but few have explanations of its relative outcome. The stock market and many investors enjoyed and were rewarded by this IPO. The analysis of this case is directed toward valuation and the unique aspects of initial public offerings.

CHASE MANHATTAN /CHEMICAL BANKS MERGER/CONSOLIDATION IN ACTION

William H. Brent, Howard University

ABSTRACT

The following case represents a consolidation of two of the banking system's largest components. Merger and acquisition activities among commercial banks continues to be a vital instrument for restructuring and reshaping the financial environment. Many members of the financial community have offered much debate on such issues as bank size, market imperfection and global competition. This 1995 merger attracted worldwide attention, especially since both banks maintained dominant position in many developed and developing countries. The stock market both enjoyed and rewarded both banks following the merger. The analysis of this case will consider both the singular and combined merger-effects on the firms' capital structure and thereby their costs of capital. Synergies resulting from the combination of the two monolithic units are explored and determined. The case has historical use for MBA students concentrating in finance or international financial management and serves as a pedagogically sound tool for applied cost of capital and merger/acquisition class sessions. The main thrust of the case is to determine the value created by the consolidation and the extent of the financial impact to financial markets, and consumers of the merger action.

MONTAGUE DECORATIVE BRICK COMPANY

Robert Stretcher, Hampton University
Michael McLain, Hampton University

CASE DESCRIPTION

The primary subject matter of this case concerns a capital asset decision faced by a small local producer of custom brick. Secondary issues include market penetration and advertising and promotion. The case has a difficulty level of four, and is designed to be taught in one class hour. It should require two and a half hours of outside preparation by students.

CASE SYNOPSIS

This case features a well respected local artist near Williamsburg, Virginia, who produces mosaic and relief designs in brick for local contractors building upscale houses. After several successful years of producing these products on a small scale, the owner/artist desires to expand operations to include both custom and production designs and to market them beyond the Wiliamsburg vicinity. The case involves analyzing the capital budgeting decision and development of a marketing strategy.

THURMOND FARMS, INC.

Michael McLain, Hampton University
Robert Stretcher, Hampton University

CASE DESCRIPTION

The primary subject matter of this case concerns the financial condition of Thurmond Farms, Inc. at the end of an extended period of hog price declines. Secondary issues include farm asset use and diversification. The case has a difficulty level of two, and is designed to be taught in one class hour. It should require one and a half hours of outside preparation by students.

CASE SYNOPSIS

This case features a small pig farming operation in eastern North Carolina. As pork prices have declined, the owners, Bill Thurmond and his son, Walt, are forced into key decisions about the life of the business and what to do with their current livestock. The case is a classic example of a microeconomic shutdown point. It is complicated, however, with the ability of the Thurmonds to diversify into other agricultural products, and to sell Timber to ride out periods of price deflation. It also highlights the point that businesses often base decisions on expectations about future prices, rather than on current prices.

CAPITAL BUDGETING AT CD INDUSTRIES: HOW TO MAKE A CHOICE

David Cary, California State University, Northridge
Michael F. Dunn, California State University Northridge

CASE DESCRIPTION

The primary subject matter of this case concerns calculation for and discussion of capital budgeting for mutually exclusive projects. Secondary issues examined include projects with uneven lives and investments, opportunity costs, sunk costs and externalities. The case has a difficulty level of four (appropriate for senior level) or five (appropriate for first year graduate level) The case is designed to be taught in two class hours and is expected to require four hours of outside preparation by students, more if a group presentation is given where each member of the group represents a different member of the board of directors.

CASE SYNOPSIS

This case involves the conflict between the president of the company who has been making capital budgeting decisions on what feels right and his sister who has recently received her MBA and want to employ a more formal capital budgeting process. Various members of the board of directors are brought into the case to present alternative points of view. The decision is between to proposals for the use of an existing warehouse. The proposals have different size investments and different lives. In addition, desire by the production manager to try new computerized equipment is weighted against the option of abandoning the project if the other proposal is accepted and sales are less than expected. Using a group presentation where each member of the group represents a member of the board of directors can be especially valuable to discuss the alternative points of view.

THE 1031 PROPERTY EXCHANGE: AN ALTERNATIVE TO THE HIGH CAPITAL GAINS TAX

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CASE DESCRIPTION

This case illustrates the complexities and opportunities for creative financing arrangements which are commonly used in today's economic environment, Specifically, it deals with various issues related to real estate tax-deferred exchanges as an alternative to paying capital gains tax. The case has a difficulty level of four (appropriate for senior level) or five (appropriate for first year graduate level) The case is designed to be taught in two class hours and is expected to require four hours of outside preparation by students.

CASE SYNOPSIS

The material presented in the case is real. One of the authors of the case, Dr. Graham, was the principal investor in this 1031 Exchange. Hence, the case will provide the student and instructor with a realism that is probably not found in similar cases. In addition, the case will provide an opportunity for students to discuss business decisions and their implications on financial accounting. Students will discuss the mechanics of Graham's financing transaction, that is, a 1031 Exchange, and will analyze his business reasons for structuring the transaction in this manners

SHORTING CORPORATE BONDS & INTRA-CAPITALIZATION

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ABSTRACT

The purpose of the paper is to explain a potentially lucrative, minimum risk strategy that has been used by sophisticated investors when a company is in financial distress. The strategy involves looking at the capital structure of the individual company, the simultaneous longing(buying) of the company's senior security(s) and the shorting(selling) of the company's junior security(s). In addition, a decision is made on the ratio of monies dedicated to the long and the monies dedicated to the short. A -full discussion of the variables is presented, such as: the probability of the company going bankrupt, the ease of borrowing the shorted securities, the margin requirements for taking the "total position," and the time constraints placed on the trade.

Many historical examples are presented including some near-riskless arbitrages. A "pseudo-algorithm/heuristic is also presented."

AMERICAN CURTAIN COMPANY

James Stotler, North Carolina Central University

BACKGROUND

American Curtain Company has been in business for many years and is considered a dominant player in the industry. American Curtain is involved in the design, manufacture and wholesale distribution of curtains and related products. Currently, they have about 25 percent of the United States curtain market and also have some international sales, although they are not considered a dominant player in the world market for curtains. The focus at American Curtain is on increasing domestic market share.

In line with this goal of increasing domestic market share, American Curtain has aggressively sought large retail accounts over the past year. As a result, current capacity is not sufficient to support recently acquired drapery hardware customers. Two hundred and eight Builders Square stores were acquired last spring. One hundred fifty one Florida Wal-Mart stores were added in June. Two hundred and four K-Mart stores were added in July. Eighty eight Georgia Wal-Mart stores were added in August and another thirty eight Wal-Mart stores are scheduled to be added in the first quarter of next year. Several smaller drapery hardware accounts have also been added recently. The Builders Square, Wal-Mart and K-Mart stores added recently represent an additional $6.83 million of drapery hardware business. These customers all demand very high levels of service and additional drapery hardware manufacturing equipment is needed to provide this service. Without increased capacity, the incremental sales from these major accounts will likely be lost because of the capacity shortfall on existing manufacturing equipment. The proposed new equipment will also provide capacity to maintain growth on existing accounts. Based on past experience, an average machine loading of 85% on the five day per week capacity of a work center is the maximum load that still allows enough flexibility in the schedule to provide the expected level of customer service. An 85% machine loading allows reserve capacity to handle peak demand periods, promotions and unexpected demand on specific items. Customer service will be compromised if the average load on a work center is much over 85%. Recently acquired drapery hardware accounts are demanding 100% line fill and even at full capacity significant backlogs still persist. If this situation continues, it is likely that some of the major new accounts acquired by American Curtain will be lost.

A significant amount of overtime is being used in an effort to meet demand with existing equipment. This overtime expense can be reduced by expanding capacity. Currently, overtime expense in the drapery hardware division totals $171,200 per year. A breakdown of this overtime expense by department can be found in Table 1.

THE PROPOSAL

Since current manufacturing capacity is not sufficient to support recently acquired drapery hardware customers and expected future growth in the customer base, it is being proposed that additional drapery hardware manufacturing equipment be installed in departments 02,04,06 and 28. These are the roll form, subassembly, packaging and curtain rod departments, respectively. The cost of the proposed equipment is $550,000 and a breakdown of these costs by department is shown in

Table 2. The marketing department at American Curtain estimates that $6.83 million in annual sales will result from the additional capacity if it is added. The first three months of the projects life will involve setup and test runs of the new equipment and therefore no incremental sales will result during this initial period.

Table 1
Summary of Overtime Costs by Department

Department	Description	Overtime Cost
02	Roll Form	$ 6,900
04	Subassembly	5,200
06	Packaging	9,700
28	Curtain rods	21,000
	Quarterly Total	42,800
	Annual Overtime Cost	171,200
	Estimated Overtime Savings	111,280

Table 2
Cost Summary

Item	Department	Quantity	Description	Capital	Overtime Cost
A	02	1	Roll Forming Lines	$230,000	
B	04	2	Subassembly Machine	37,000	
C	06	2	10" Rennco Packing Line	114,000	$ 5,000
D	28	2	52" Rennco Packing Line	159,000	5,000
			Totals	540,000	10,000
			Total Project Cost	550,000	

American Curtain has a well established history of producing quality draperies and drapery hardware and has determined that the cost of sales for drapery hardware is 60% of sales. Selling, general and administrative expenses associated with drapery hardware manufacturing and sales are typically 16.5% of sales but for the first year of operation, these expenses are expected to be much higher. American estimates that these selling, general and administrative expenses will be 36% of sales for the first year of the project. Overtime costs (See Table 1) are expected to drop by 65% as a result of the expanded production capacity.

New drapery hardware customers will be extended the same credit policy as existing customers which would increase accounts receivable by $650,000 in the first year and $225,000 in the second year after which no further increases would be required. Additional inventory of $600,000 would be required in the first year and $200,000 in the second year, after which no further inventory increases would be required to maintain the increased capacity.

Table 2A
Roll Forming Lines (Department 02)

Item	Quantity	Description	Cost
1	2	Dahlstrom Roll Mill	$ 100,000
2	2	A.C. Drive for Roll Mill	15,000
3	2	Littell Double Automatic Centering Reel	14,000
4	2	Encoder System and Line Controls	10,000
5	4	Hydraulic Press	75,000
6	2	Custom Built Rod Straightener	5,000
7	2	Adjustable Entry Guide	2,000
8	2	Custom Built Run Out Table	3,000
9		Installation	6,000
		Total	230,000

Table 2B
Subassembly Equipment (Department 04)

Item	Quantity	Description	Cost
1	2	Dixon SD-107 Screwdriver	$ 24,000
2	2	Base and Stand	3,000
3	2	Hoppers	2,000
4	1	Feeder Bowl Assembly	5,000
5		Freight and Installation	3,000
		Total Capital Cost	37,000

Table 2C Rennco Packaging Equipment (Department 06)			
Item	Quantity	Description	Cost
1	2	Rennco Packaging Machine	$ 80,000
2	1	Doboy Poly Header Machine	18,000
3	1	Screw Feeding attachment	10,000
4		Freight and Installation	6,000
		Relocation Expense	114,000
		Total Capital Cost and Expense	119,000

Table 2D Rennco Packing Lines (Department 28)			
Item	Quantity	Description	Cost
1	2	Rennco 501-52 Packaging Machine	$ 74,000
2	2	Out Feeder Convoy	6,000
3	2	Doboy Poly Header Labeling Machine	36,000
4	2	Pack Table	2,400
5	2	L-Clipper Tape Table	7,600
6	2	Scissors Lift	8,000
7	2	Assembly Tables and Fixtures	5,000
8	1	Rod Skid Storage Fence	4,000
9		Freight and Installation	6,000
		Total Capital Cost	159,000
		Relocation Expense	5,000
		Total Capital Cost and Expense	164,000

The capital expenses associated with the project are detailed in Table 2. American Curtain depreciates capital items of this nature using straight line depreciation. Tax regulations require the use of a IO year depreciable life on this class of assets. American analyzes projects of this nature using a four year investment horizon and estimates that the market value of the equipment at the end of four years will be $324,000. American is in the 39.5% corporate marginal income tax bracket and has a 10 percent weighted average cost of capital.

QUESTIONS

1. Prepare a projected income statement for each of the four years of the projects life.

2. Determine the additional working capital required for this project.

3. What are the annual cash flows from this project?

4. Compute the Net Present Value of the project.

5. Compute the Internal Rate of Return for the project.

6. Compute the Payback and Modified Payback Period for the project.

7. Based on the values computed, is the project acceptable?

8. Discuss some possible alternatives to this project which American Curtain Company may want to consider.

AN ALGORITHM TO SPLIT THE PIE WHEN A PUBLIC COMPANY DECLARES CHAPTER XI BANKRUPTCY

Jeffrey Schultz, Christian Brothers University

ABSTRACT

This project predicted the bankruptcy of Penn Traffic and showed how one can divide the bankruptcy estate in a pre-packaged bankruptcy for most soon to be bankrupt public companies with various classes of creditors.

BRIEF HISTORY OF BANKRUPTCY IN THE UNITED STATES

In ancient Italy, when a businessman did not pay his debts, it was a practice to destroy his trading bench. The word "banca rotta" is Italian for broken bench; this is where the term bankruptcy originated. Before the 20th century, rules and practices concerning bankruptcy generally favored the creditor and were extremely harsh toward the bankrupt. The main focus was on creditor recovery and practically all bankruptcies at this time were involuntary. In England, the first official laws concerning bankruptcy were passed in 1542, under King Henry VIII. A bankrupt individual was considered a criminal and was subject to criminal punishment Potential punishments ranged from "jail time" in debtor's prison to the death penalty.

In the United States, early federal bankruptcy laws were temporary responses to bad economic conditions. The first official bankruptcy law was enacted in 1900 in response to land speculation. It was repealed in 1903. Similarly, in 1841, in response to the panic of 1837, the second bankruptcy law was passed. It was repealed in 1843. The economic upheaval of the Civil War caused Congress to pass another bankruptcy law in 1867, which was repealed in 1878. All of these laws contained some allowance for the discharge of unpaid debts. The first two laws, those of 1800 and 1841, allowed only minimal discharge of debt. The 1867 law was the first to include protection for corporations.

Modern bankruptcy laws and practices in the United States emphasize rehabilitating .(reorganizing) debtors in distress. The Bankruptcy Act of 1898 was the first to give companies in distress an option of being protected from creditors. The company could be placed in an “equity receivership." This reorganization provision was made much more formal and extensive in the United States during the 1930's. The economic upheaval of the Depression yielded much bankruptcy legislation, in particular, the Bankruptcy Act of 1933 and the Bankruptcy Act of 1934. This legislation culminated with the Chandler Act of 1938, and included substantial provisions for the reorganization of business.

During the period from World War II through the 1970s, bankruptcy topic in the news. With the exception of railroads, there were not many notable business failures in the United States. During

'the 1970s, there were only two corporate bankruptcies of prominence, Penn Central Transportation Corporation in 1970, and W.T. Grant in 1975.

The Bankruptcy Reform Act of 1978 was passed and took effect on October 1, 1979. This act substantially revamped bankruptcy practices. A strong business reorganization chapter was recreated, Chapter XI. (This replaced the old Chapter X, XI, and XII that had been created by the 1898 act and amended by the Chandler Act). Similarly, a more powerful personal bankruptcy, Chapter XIII replaced the old Chapter XIII. In general, the Reform Act of 1979 made it easier for both businesses and individuals to file a bankruptcy and reorganize. The 1978 Act, a major piece of legislation, started a number of legal controversies. Many amendments and judicial clarifications of the 1978 Act were made during the 1980s. One major event was the 1982 Supreme Court ruling that the bankruptcy court's enlarged jurisdiction, which was established by the 1978 Act, was unconstitutional. The Supreme Court ruling stated that Congress had given bankruptcy judges too much power and their duties overlapped with those of other branches of the United States government. The 1982 ruling led to the Bankruptcy Amendment Act of 1984.

There were a number of other notable developments in bankruptcy rules during the 1980s. The 1978 Act did not cover tax-related issues and was addressed by the Bankruptcy Act of 1980. The Tax Act clarified such things as tax loss carry-forwards and taxation rules where there is an exchange of equity for debt A 1983 Supreme Court ruling challenged the ease with which companies could protect themselves from labor contract while in bankruptcy. The Bankruptcy Amendment Act of 1984 limited the right of companies to terminate labor contracts.

During the late 1980s and early 1990s record numbers of bankruptcies of all types were filed. Many well known companies filed for Chapter XI protection. Included were LTV, Eastern Airlines, Texaco, Continental Airlines, Allied Stores, Federated Department Stores, Johns Manville, Greyhound, R. H. Macy, and Pan Am. Several of the large cases, such as Olympia & York, have added the complexity of involving the insolvency laws of several different countries. These massive bankruptcies challenged the court system, that handled it well.

New techniques, such as "prepackaged" bankruptcies, allowed the court system to handle the increased caseload of the late 1980s and early 1990s fairly efficiently. However, there still remained substantial concerns about the level of professional fees and apparent waste of corporate assets in many bankruptcy cases. In several of the larger cases the fees have "eaten" as much as 30% of the total Estate. The professionals spend countless hours "fighting, not negotiating" over how the Estate (or Pie) should be divided when the slimmed down Company emerges from Chapter XI bankruptcy. This paper will attempt to provide a pseudo-algorithmic, maybe heuristic approach to dividing the spoils among creditors and equity holders of a Chapter XI bankrupt company. The company, Penn Traffic Corporation, will be used as a "guinea pig". Penn Traffic has yet to file Chapter XI bankruptcy as of September 8, 1998, but should in the next several months, if not days.

PENN TRAFFIC

Business

Penn Traffic operates 263 supermarkets in Pennsylvania, upstate New York, Ohio, and northern West Virginia under the names Riverside Markets, Bi-Lo Foods, Insalaco's, Quality Markets, P&C Foods, and Big Bear. Penn Traffic owns and operates Johnstown Sanitary Dairy, a dairy processing plant. in addition, it Owns and Operates Penny Curtis Bakery, which provides 'P&C's

stores with private label fresh and frozen bakery Products. Penn Traffic also serves 114 licensed franchises and 99 independent operators throughout its wholesale food distribution business. Penn Traffic is attempting to sell its Bi-Lo Pennsylvania stores and related wholesale operations to raise much needed cash to reduce debt and remain liquid.

Capital Structure of Perm Traffic		$(millions)
Debt:	Secured-Bank Group	$250
	Unsecured-Senior Bonds	
	8.625% due 12/15/03	$200
	10.25% due 10/02/02	125
	10.375% due 10/01/04	100
	10.65% due 11/01/04	100
	11.50% due 10/15/01	107
	11.50% due 4/15/06	100
	Total Senior Debt	$732
	Capital Leases	$139
	Unsecured-Senior Subordinated	$400
Common Shares: 10,600,000		

Penn Traffic reported second quarter cash flow of $28,000,000 for its August 1998 .numbers. Cash flow (EBITDA, Earnings before Interest, Tax, Depreciation and Amortization) will be the most important variable -used in determining the Estate portion in Chapter XI Bankruptcy). The previous EBITDA came in around$30,000,000. If we annualize the EBITDA we are looking . at $115,000,000. The industry multiple of what a grocery chain is worth 5.5 times EBITDA. Thus if Penn Traffic files for bankruptcy in the 'near future, we have an Estate value in the $600,000,000 to $675,000,000 range. This could be a starting point for what is in the pie. Next comes the hardest part: who gets what and in what form of payment.

The paper will explain the Estate evaluation process and the division process once a company files for a Chapter XI bankruptcy process. Thus, if the time it takes a debtor to leave Chapter XI is shortened because of less in fighting between creditors, equity holders, and the debtor, there will be more left in the Estate to be distributed.

WHO ARE THE CREDITORS IN A CHAPTER XI BANKRUPTCY?

We could divide the creditors into two major classifications: (i) secured and (ii) unsecured. The secured could be further divided into secured over-collateralized and secure under-collateralized. The unsecured creditors consists of trade creditors, real estate creditors, (retail leases), senior

debentures, Senior subordinated debentures, subordinate debentures, junior subordinate debentures, etc. In addition, if the corporation is a holding company, the creditors could be creditors of the holding company or its subsidiary. The creditors' holding make up the liability side of the equation. The creditors are the entities that get the pieces of the pie.

"The Pie"

The pie is a function of the total assets and the potential cash flow of the Estate. In most Chapter XI cases the unnecessary assets are sold or should be sold, if possible, and the monies generated could be used to satisfy certain prioritized creditors or to "beef up" the working capital needed by the corporation that will ultimately emerge from the Chapter XI proceeding. Once determined what the form of the entity will look like, one could evaluate its value. If the company is in retailing, such as Macys; a multiple of expected EBITDA (cash flow) of 5.5 to 7 times is and was the norm. A deep discount health and beauty aid company, such as Revco and Pharmore, was evaluated at 5 to 6 times EBITDA. An entertainment and toy manufacturer, Toy Biz/Marvel Entertainment, was evaluated at 6.5 to 9 times EBITDA. These multiples derive from the point at which similar types of public companies sell.

Penn Traffic, our example, should be evaluated like other non-bankrupt retailers at a multiple 5 and 6 times EBITDA. An expected 1999 calendar year EBITDA of $90 to $110 million generates an Estate value that should be given to the public bondholders and shareholders as well as the real-estate trade creditors. This will result in a substantial shortfall to the bondholders of Penn Traffic. The bigger the shortfall, the larger the haircut the creditors will have to take. How much of a haircut? If one uses a 15 to 1 step-down ratio of senior Penn Traffic debt to Penn Traffic subordinated debt; we would get a range of $422 million to $619 millions value to. the senior and $28 million to $41 million in value to the senior subordinates This value must be given to the rejected real estate lease. Assume $40 million of claims are for the rejected leases from the closed 450/1132 to 660/1132 [note: there is $732 million of senior bonds and $400 million of subordinated bonds], this works out to 40% to 48% of principal claim. Thus, real estate trade would probably get around 50% of its claim, or about $16 million in value. If the Estate is worth $550 million, this works out to be 3% of the Estate.

How do we satisfy the claims? If we use a 100% equity plan, where the secured debt stays in place; 92% senior, 5% subordinates, and 3% real estate, and if the common equity needs to get **a** "bone" for nuisance value; they could be given 1% from the subordinates. Both the subordinates and equity can also be given “wish paper” in the form of warrants. If the subordinates demand more equity, the senior might be able to give up some equity for debt, if the company is capable of handling it.

How much debt can the post Chapter XI company handle? This is a function of EBITDA. $100 million of annual EBITDA/I ratios would be much more preferable to the “street.” With a secured working capital of $250 million, Penn Traffic would have interest expenses of $25 to $30 million already. This leaves little room for the seniors receiving any debt in lieu of common stock. Therefore, a new capital structure of post Chapter XI Penn Traffic would look like:

Debt: $200 million - $250 million secured debt

Common: 50,000,000 shares
(46 million shares to seniors)
(2 million shares to subordinates plus warrants)
(1.5 million shares to real estate trade)
(.5 million shares to equity plus warrants)
Rough- "back of the envelope" value of common: $ 10/share

Recovery to seniors-63 cents on the dollar
Subs-5 cents on the dollar plus warrant value

What am I leading up to? A pseudo-algorithmic process to developing a Chapter XI, preferably a "prepackaged" bankruptcy plan with the minimal amount of time and professional pain.

A. Calculate the bankruptcy claims and their priority status.

B. Identify assets that are not needed, and attempt to sell them as quickly as possible, to raise cash.

C. Estimate the most likely future EBITDA from management's business plan.

D. For the particular industry the bankruptcy company evaluates what a multiple EBITDA the company is worth.

E. As A through D is being accomplished; the unsecured should negotiate in a reasonable way, who gets what. In the negotiations an all equity plan should be assumed. The more subordinated claims can get more equity, only if the senior claims get cash of debt for the equity they give up. If it is senior versus subordinate, the seniors should get at least 90 to 95% of the pie (up to their total claim) with the subs and equity getting the remainder. If there is impaired trade and real estate debt, they must be satisfied taking both from the senior and subordinate portions of the pie.

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