Marvel case

Entertainment, Movie

MARVEL ENTERTAINMENT GROUP

Bankruptcy and restructuring Introduction Marvel entertainment group was started by Martin Goodman in 1939. It originally was a comic book business, known as Marvel Comics now. We have no way to forget the images of X-men, Spider-Man, and Thor. Marvel Entertainment Group has had a glorious history, and a dominant position in the comic market. However, this glorious empire regretfully elapsed in the end. The historical rise and fall influences not only comic fans' life, but most importantly to its investors and the financial market.

Here we discuss in detail about the reason Marvel file for bankruptcy, the evaluation of the restructuring plan, equity worth per share under restructuring plan, its influence on the debt rising ability to other firms in the group, and why the portfolio managers choose to sell their zero coupon bonds. Part 1 Analyzing problems: why did Marvel file for Chapter 11? Were the problems caused by bad luck, bad strategy, or bad execution? After taking a deep look into its performance of a six-year period, we reached the conclusion that the fall of this comic star is mainly caused by bad strategy it adopted, especially the one to acquire Skybox.

Though the first two issuance of debt did bring along good operating results, Marvel's core business began to falter shortly after the third issuance. The sales of three major business lines: Sports and Entertainment Cards, Children's Activity Stickers, and Published comic books all decline significantly after 1993. The main reason for this decline can be explained by the fact that child entertainment is becoming more diversified, with

alternatives appearing such as video games. Besides that, collectors' declining willingness to invest in comic books drive the sales down dramatically.

However, these reasons have little things to do with luck: because a successful and experienced entertainment company like Marvel should have the ability to notice this kind of demand change. What is more, sufficient market research should also be done when deciding long-term business strategies. But the creator of Spider man really disappointed us by heading for a totally wrong direction at the turning point of this industry. To be qualified as a bad strategy adopter, Marvel decided to acquire Skybox in 1995. At that time, Marvel has a leverage ratio as high as 52%, which made it hard to pay back the huge debt when revenues are declining.

Moreover, the declining demand for entertainment cards will make this expansion unlikely to boost its revenues. We can see more clearly from its operating and financing ratios that this acquisition resulted in worse performance of the whole Marvel group. Marvel's operating and leverage ratios 1991. As we can see from the number facts above, both operating and leverage ratios show that bad performance of the company became even worse after the acquisition. On one hand, during this six-year period, Marvel's operating ratios decreased greatly: Net Income/ Sales dropped from 13. 99% of 1991 to -4. 80% of 1996. Besides, the cost of Sales/Sales rose significantly from 50. 57% to 64. 07%. At the same time, SG&A/Sales also increased from 18. 6% to 28. 9%.

On the other hand, the leverage ratios also showed that the leverage is already quite high before it made the acquisition decision. During the period

from 1991 to 1995, the operating results were not satisfying and leverage coverage kept falling. Based on this situation, Marvel’s decision makers still expanded further, resulting in a worse situation: after the acquisition, its interest coverage ratio dropped rapidly to only 0. 96; the EBITDA/Sales ratio also declined to 7. 02%. Therefore, we can see clearly that the bad strategy Marvel adopted is the main reason for its bankruptcy.

When facing with both an internal problem—financial distress, and external threats—declining demand for cards, Marvel should absolutely seek growth within existing business rather than impudently expand through acquiring Skybox. Part 2 Evaluation of the proposed restructuring plan: will it solve the problems that caused Marvel to file Chapter 11? As Carl Icahn, the largest unsecured debt holder, would you vote for the proposed restructuring plan? Why or why not? In early 1996, Perelman announced a restructuring plan in order to bail out.

According to the plan, $365 million would be invested in Marvel in exchange for 427 million new Marvel shares to maintain the 80% ownership; Marvel would acquire Toy Biz, using its revenue to serve Marvel’s debt and offset Marvel’s NOLs; debt with a face value of $894. 1 million would shift into equity. In our perspective, this new plan can only solve part of Marvel’s recent problems, while it would be helpless to completely help the company out. The proposed restructuring plan is supposed both to relief Marvel’s debt burden and to increase the liquidity. To achieve this goal, Marvel planned to increase equity investment, and retire 894. million of debt, whose interest would be secured by 77. 3 million of Marvel’s shares. In these cases, Marvel would acquire new financing support without giving away part of its

ownership, which is vital for the tax and NOLs purpose of the company. Besides, the leverage ratio would decrease sharply as a large proportion of debt would turn into equity, given that the market price of stock would not decline significantly. As a result, the plan could solve the liquidity problem of Marvel, as well as solve the problem that led Marvel to violate specific bank loan covenants.

However, the company misemployed the newly acquired liquidity in the wrong place. Rather than transforming its original business strategy, which is problematic, into newly emerging industries such as video games to increase revenue, Marvel would maintain its original business lines, majority of which face downturns in the market. At the meantime, Marvel would continue to expand its current business by acquiring remaining shares of Toy Biz. As what was mentioned previous in this report, the main reason why Marvel filed Chapter 11 was that it mistakenly bought business that produces non-demanded products.

S&P downgraded the company’s debt by noting that Marvel’s earnings “ have fallen while it has added debt to make acquisitions”. To acquire Toy Biz, an estimated $361. 5 million would be paid in cash by Marvel. Though Marvel believed that the acquisition would help generate sustainable cash flow to the company, we consider the revenue of Toy Biz, a company which is closely related to Marvel’s current business lines, is far from guaranteed as a foreseeable downturn in traditional entertainment industry. It means that the relieved debt burden could be ultimately offset by the prudent acquisition.

Marvel would be inevitable in crisis. Furthermore, the debt holders, debt of whom would be transformed into equity, would not be fully paid off. After the

restructuring plan was announced, the stock price of Marvel plummeted. From what was shown in Exhibit 3, Marvel’s stock price continued to decline afterwards. Under the downward pressure of share price, the value of the collateral shares for the bonds are now much lower than it used to be at the time of the bonds being issued. In other words, the new shares could now only cover partially the face value of original bonds.

For Carl Icahn, the largest unsecured debt holder who would have to invest in the highly discounted share once the restructuring plan is passed, whether or not its investment could be paid back would be doubtful. Though Bear Stearns, a company who prepared financial projections for Marvel’s acquisition of Toy Biz, predicted modest growth for Marvel and significant growth for Toy Biz, and that Marvel was valued more as a going concern, the argument of Bear Stearns is questionable and hard to be guaranteed. Therefore, as Carl Icahn, we would not vote for he proposed restructuring plan. Part 3 Evaluation of Marvel’s equity: how much is Marvel’s equity worth per share under the proposed restructuring plan assuming it acquires Toy Biz as planned? What is your assessment of the pro forma financial projections and liquidation assumptions? We proceed to estimate equity worth per share by employing the capital cash flow method. Capital cash flow valuation incorporates mainly two approaches: starting with NI or starting with EBIT. Concerning the difficulty of reaching for such items as EBIT, we prefer the NI method particularly.

Then the whole valuation process could be divided into two parts: calculation of PV (CCF) and number of shares. Part 1: PV (CCF) How to determine the discount rate is crucial for PV (equity value). This valuation uses data from

Exhibit 10. Marvel entertainment group asset beta Risk-free rate Risk premium Pre-tax WACC Note: Pre-tax WACC = Rf + ? a * risk premium We use the five-year yields on US treasury bills, notes, and bonds for correspondence with our estimation time range starting from 1997 and ending in 2001. It gives us the pretax WACC as 11. 35%, used as our discount rate in the case. Then we proceed to the next section of CCF, based on information on Exhibit 9. Table 3. 1 has all the calculations shown in explicit steps with our desired result as equity value = 435. 99. Part 2: number of shares outstanding Up till now, equity value per share is only one step away with the missing number of shares, which is presented directly underneath Exhibit 6, as 528. 8 Therefore, we can come straightforward to the final calculation as: Equity value per share = 435. 99/528. 8 = 0. 2 What makes this case special is that distressed M&A could offer substantial corporate strategy opportunities in the troubled economic times ahead, while at the same time, the value of such opportunities could often be hidden amidst the confusion and distress of bankruptcy, such as the one listed as follows. Liquidation value is presented in table 3. 2. 0. 65 6. 36% 7. 5% 11. 235% Part 4 Will it be difficult for Marvel or other companies in the MacAndrews and Forbes holding company to issue debt in the future? Yes. It will become much harder for other companies in the MacAndrews and Forbes holding company o issue debt in the future, under the influence of Marvel’s bankruptcy. In 1995, S&P and Moody’s downgraded the holding companies’ debt from B to B-. Again, in 1996, Moody’s downgraded Marvel’s public debt once more. After the huge volume debt of Marvel downgraded by two rating agencies, Marvel had announced that it would violate specific bank loan

covenants due to decreasing revenues and profits. Because downgrading of debt increases the chance of default, and the default probability would surely bring difficulties to other companies in the MacAndrews and Forbes holding company to issue new debt.

This would happen step by step. First, the low credit rating indicates a high risk of defaulting on a loan and, hence leads to high interest rates or the refusal of a loan by the creditor. Then, Investors realize this risk and therefore would require a higher default premium to compensate the risk. After that, increased default premiums would raise the cost of capital for the holding company. Given the increased risk premium and default possibilities, Marvel and other companies in the MacAndrews and Forbes holding group would having more difficulties issuing new debt in the future.

Some difficulties would be generated from Perelman, because debt holders and creditors where raising questions about the integrity on the judgment decisions from Perelman. Judge Balick approved Marvel did not discriminate unfairly against non-affecting creditor classes and provided it was fair and equitable to all classes. In reaction, a lawyer challenged the Bearn Stern’s conclusions and insinuated Bearn Sterns had multiple levels of conflicts due to the contingency fee provided by Perelman. In the end even the Vice-Chairman of the Andrew group had to come with a statement to overcome all the negative sounds in the market.

Anyhow it looks like Perelman’s reputation was damaged already. Also, this would influence the whole company’s reputation and the credibility of issuing new debt. Part 5 Why did the price of Marvel’s zero-coupon bonds drop on Tuesday, November 12, 1996? Why did portfolio managers at Fidelity and

Putnam sell their bonds on Friday, November 8, 1996? On Nov 12, 1996, Marvel’s zero-coupon bonds fell by more than 50% when the spokesman for the Andrews Group announced the details of the proposed restructuring plan. According to he announcement, Perelman was to purchase, through Perelman-related entities, 410 million shares of newly-issued Marvel common for $0. 85 per share, 81% discount to the then prevailing market price of $4. 625. After Marvel met the managers of Fidelity and Putnam, those two institutional investors sold their Marvel bonds on hand immediately in response of the meeting before the announcement of the restructuring plan. Public holders predict Fidelity and Putnam should have the insider information about the restructuring plan.

Their action made the public holder feels the restructuring plan is not favor to the bond holder and therefore sold it to avoid a greater loss. Apart from that, Marvel’s zero-coupon bonds were secured by its equity, rather than the company’s assets or operating cash flows. Due to the problem Marvel suffered, their share price dropped. Once the stock price dropped below $11. 6 per share, the collateral would not be sufficient to cover the debts. The public debt holders might consider that these bonds were no longer worthy to be held to maturity while the credit risk soared. Therefore they sold the bonds in arge quantity under the deteriorated signals in the market. As a result, the bond price plunged. Due to the restructuring plan, the prices of Marvel’s shares and bonds dropped 41% and 50% respectively. On Nov 8, 1996, Howard Gittis, vice chairman of Andrews Group, called Fidelity Investments and Putnam Investments, two of the largest institutional holders of Marvel’s public debt, and asked them what they would like to see in are

structuring plan. Portfolio managers at Fidelity and Putnam decided to sell more that $70 million of Marvel bonds at a price of $0. 37 per dollar of face value on the next day.

Perhaps, during this conversation, they got some detail information of the plan which proved the present value of Marvel’s bonds was overvalued. It gave the chance for them to avoid tens huge losses in diminished value that would have followed and suffer the time they continued to hold the bonds already existing facts were revealed. To explain the portfolio managers at Fidelity and Putnam sell their bonds on Friday, November 8, 1996, we can compare the value of the bond value at the market and the expected equity value belong to the public holders after restructuring, Bond value on November 8, 1996, Face value of $894mn X 0. 37per dollar of face value = $ 330mn Equity value belong to the public holders after restructuring, $ 77mn shares X $0. 49 (our projected equity worth per share) = $ 38mn We found that the market value of the Marvel bond is far higher than the value of the future equity worth belongs to the bondholders. So, the bond selling price of Fidelity and Putnam is relatively much attractive rather than the converted equity value after the restructuring plan. Conclusion

In the above analysis, we reached at the conclusion that Marvel’s bankruptcy mainly resulted from its bad strategy and management problems. First, it chose to expand in a wrong time and to a wrong direction. Second, its restructuring decision can only solve its liquidity problem temporarily, and Carl Icahn should veto the restructuring plan. Third, Marvel Entertainment Group in this case will have bad influence on other companies and make it

hard for them to issue new debt in the future. We also use the capital cash flow method to calculate the equity worth under the restructuring plan.

Generally speaking, it does sound that attractive and only resulted in investors' chagrin. Table 3. 1 (millions) Net (loss) income + depreciation or amortization - change in working capital - capital expenditure + amortization of goodwill - equity in net (loss) income in unconsolidated subsidiaries + minority interest in Toy Biz + provision for deferred taxes +Interest Capital cash flow Growth rate of each year Geometric growth rate Discount rate Present value of CCF Sum of Present value Debt value of Sept. 996 Equity value ? ? ? Terminal cash flow = CCF2001 * (1+g)/(r-g) We use geometric average here because of the rule of thumb: the more volatile the return stream, the more important it uses geometric average Because the market value and book value of debt are nearly the same, we directly subtract the debt value from Sum of PV (CCF) to get the final equity value.

Terminal CF 1022. 67 Table 3. Liquidation value Cash Accounts receivable Inventory Deferred income tax Income tax receivable Prepaid expenses and other current assets Current assets PP&E (net) Goodwill and other intangibles (net) Investment in subsidiaries Deferred charges and other assets Total assets Accounts payable Accrued expenses and other current liabilities Short-term borrowings Current portion of long-term debt Current liabilities Long-term debt Other long-term liabilities.

Note: all adjustments are based on our group's estimations, prepared from the 1996 standpoint. ? The second entry accounts receivable is adjusted downward to 85%, based on the " rule of thumb" of liquidation situations, note (2L), (5L), and (8L) are done likewise.

To make it more precise, expert appraisers are needed for specific consultation. ? Notes (3L), (4L), (7L), (9L), (10L) and (11L) identify the items written down to zero if liquidized. ? Note (6L) were written down to 50% because of the perceived value of Marvel’s character portfolio (Spiderman and X-man did enable them steal the thunder), while we still need someone expertise for more accurate estimation. ? Lastly, subtracting liabilities from assets in Table 3. 2 gives us the liquidation valuation of $424. 7 million