



**Level III
of the
CFA® Program**

Constructed Response Set
Private Markets Pathway

Essay 3 : Meridian Capital

Learning Outcomes Covered:

LM(S) 5: (Private Special Situations)

LOS: Discuss the features of distressed debt, financing alternatives for issuers in financial distress, and investment strategies in distressed situations.

LOS: Discuss the due diligence and valuation processes used to evaluate special investment situations.

LOS: Discuss the risk and return among special situations and compared to other forms of private debt as part of a strategic asset allocation.

TOTAL POINT VALUE OF THIS QUESTION SET IS 12 POINTS

Meridian Capital

Meridian Capital, a **distressed debt investment firm**, is evaluating securities issued by **Horizon Hotels & Resorts**, a U.S.-based hotel operator facing severe financial distress. Horizon's debt, which matures in **nine months**, currently trades at **USD 8.2 billion in the secondary market**.



TOTAL POINT VALUE OF THIS QUESTION SET IS 12 POINTS

Meridian Capital

Meridian's analysis suggests two potential scenarios:

1. As a **going concern**, using comparable publicly traded U.S. hotel chains, Horizon has an estimated **enterprise value of USD 12.5 billion**.
2. In a **default scenario**, which Meridian estimates has a **25% probability**, the liquidation value of Horizon's **assets would be USD 4.5 billion**.



TOTAL POINT VALUE OF THIS QUESTION SET IS 12 POINTS

Meridian Capital

The current capital structure consists of:

- **USD 6 billion senior secured** debt (trading at USD 5.7 billion).
- **USD 4 billion junior subordinated** debt (trading at USD 2.5 billion).
- Total face value of debt: USD 10 billion.



TOTAL POINT VALUE OF THIS QUESTION SET IS 12 POINTS

Meridian Capital

Several Meridian investment committee members have questioned the use of comparable company analysis for valuing Horizon, suggesting that a **discounted cash flow approach might be more appropriate** given the company's unique circumstances.



TOTAL POINT VALUE OF THIS QUESTION SET IS 12 POINTS

Meridian Capital

Market observations:

- **Risk-free rate:** 4% annually.
- **Credit default swap (CDS)** spreads on Horizon's debt trade at **850 basis points**.
- **Cash bond spreads** trade at **750 basis points**.
- **High trading volume** in both CDS and cash markets.



Question 1

Recommend whether Meridian should invest in Horizon's debt. (3 pts)

Question 2

Evaluate the choice of using comparable company analysis versus discounted cash flow analysis for valuing Horizon as a going concern. (3 pts)

Question 3

Recommend a capital structure arbitrage trade involving Horizon's senior and junior debt. Support your recommendation with calculations. (3 pts)

Question 4

Explain how Meridian could create a synthetic long position in Horizon's bonds using CDS. **Identify** all required components of the trade. (3 pts)

Q1. Recommend whether Meridian should invest in Horizon's debt. (3 pts)

Constructed Response

Methodology:

Step 1: Calculate Expected Enterprise Value in Nine Months

Step 2: Calculate Expected Value of Debt in Nine Months

Step 3: Calculate Implied Return for Nine Months

Step 4: Compare the implied return to the risk-free rate to see if it justifies the investment.



Grading



Correct expected value calculation: 1 point; Accurate return calculation: 1 point; Well-reasoned recommendation: 1 point

Q1. Recommend whether Meridian should invest in Horizon's debt. (3 pts)

Constructed Response

Methodology:

Step 1: Calculate Expected Enterprise Value in Nine Months

Using the two scenarios provided:

Going Concern Scenario (75% probability): Enterprise value of USD 12.5 billion.

Default Scenario (25% probability): Liquidation value of USD 4.5 billion.

$$\begin{aligned}\text{Expected Enterprise Value} &= (0.75 \times 12.5) + (0.25 \times 4.5) \\ &= 9.375 + 1.125 = 10.5 \text{ billion}\end{aligned}$$

Grading



Correct expected value calculation: 1 point; Accurate return calculation: 1 point; Well-reasoned recommendation: 1 point