Reprinted from
The Journal of Corporate Renewal

VALUATION ISSUES

Triple Trouble: Valuating Companies in Chapter 11

By David Powlen, Managing Director, Western Reserve Partners

Valuation is often a central question at various points in a Chapter 11 case. In particular, if the primary players involved do not explicitly or implicitly reach a consensus on the total value of a company as of the effective date of its reorganization plan, then the Bankruptcy Court may be faced with one of the more difficult determinations required of it in a business bankruptcy case.

Just as reaching a temperature of absolute zero is not possible under the laws of thermodynamics, achieving absolute certainty is not possible using even the best and most accepted methods for valuation of an enterprise. Pegging a single figure, or even a range of numbers, on a company in any situation entails not just the "science" of following various generally accepted approaches to arrive at worth, but also the "art" of implicitly or explicitly developing assumptions, making predictions, and exercising judgment.

Assessing the value of a company in Chapter 11 is typically more difficult than for a healthy business with a demonstrated track record and stable or growing earnings. Yet another layer of complexity results when the company is in a cyclical industry or is being impacted by a general economic downturn.

Thus, professionals in the turnaround industry and bankruptcy judges may confront triple trouble: the inherent imprecision of valuation, the additional complications of a distressed company in bankruptcy, and the extra difficulty of taking into account the cyclicality of an industry or turns in the general economy.

Purposes of Valuation

Sometimes in a bankruptcy case the valuation of a debtor as of an earlier date — prior to the inception of the case — may be needed. When an adversary proceeding is filed to recover an alleged fraudulent or preferential transfer, a finding must be made by the Bankruptcy Court (sometimes with the benefit of a "presumption" of insolvency built into the Bankruptcy Code)[1] about whether the company was insolvent at the time of the transfer.

> Management's projections of the future may be overly optimistic or fail to take into account that the company starts with some disadvantages to its peers from the mere fact that it has been troubled and in bankruptcy.

Also, a valuation of a company as of the date it files for Chapter 11, and perhaps again months after the filing date, may be desired. For example, such valuations could be entailed in assessing whether a primary secured creditor that has a lien on substantially all of the company's assets is faced with deterioration in its collateral after inception of the case and therefore may be entitled to adequate protection of its petition date position.

As a reorganization case progresses toward possible confirmation of a plan, another matter of valuation becomes central. What is or will be the enterprise value of the company at the time its plan becomes effective and it emerges from Chapter 11?

This figure almost always underlies or is embedded in the proposed structure of the company's Chapter 11 plan (unless perhaps it is one of liquidation), which sets out the relative priorities and classes of creditors, and states who will be paid and how much. The company's position on valuation is most often specifically addressed in the disclosure statement that accompanies its Chapter 11 plan.

If there is no controversy among interested parties, then the company's proposed valuation will in effect determine, as examples, whether and to what extent a primary secured creditor will obtain periodic payments on its restructured loan, general unsecured creditors might receive some dividend on their pre-petition claims, and holders of old equity interests may have any continuing stake in the reorganized company.

Basic Valuation Methodologies

As a starting point in determining the total or "enterprise" value of either a healthy or a troubled firm, there are three generally accepted conceptual categories or methods that might be used. They are often labeled as the market approach, the income approach, and the asset approach (**Figure 1, see page 2**).

The market approach involves examining how similar companies are valued and then comparing them to the subject company. Two separate analyses are usually employed:

- ***Comparable public company analysis.*** A set of public companies is chosen that closely resembles the subject firm with respect to customers and markets, revenue mix, size, profitability, etc. The comparable set's market value as a multiple of a financial metric — *e.g.,* earnings before interest, taxes, depreciation, and amortization (EBITDA); earnings; or revenue — is then applied to the subject firm.
- ***Comparable transaction analysis.*** Merger and acquisition (M&A) transactions involving targets that resemble the subject firm are analyzed with respect to the transaction value as a multiple of various financial metrics. The resulting multiples are then applied to the subject firm.

Several important questions may arise in employing these two analyses under the market approach to value, including:

- Is the comparable set truly representative of the subject firm?

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- What financial metric(s) will be used?
- Should the metric(s) be based on historical or projected figures?
- Should any discounts or premiums for size, comparability, or other factors be applied to a particular multiple?
- What time frame for comparable M&A transactions and other data should be reviewed?

The income approach to valuation is based on discounted cash flow (DCF) methodology, which finds the present value of future cash flows that are expected to be received by the combination of the company's creditors and equity holders. The DCF method also has a variety of areas in which views and figures can reasonably vary, including:

- ***Projections.*** What assumptions apply to the company's future revenue, cost of goods, overhead, capital requirements, and other operating items?
- ***Cost of Capital.*** What is or should be the average cost of the company's debt and equity going forward[2] from which to derive the discount factor that will applied to the company's expected cash flows?
- ***Terminal value.*** Cash flows are typically projected for five to 10 years. Should the value of the company at the end of the projected period be based on an exit multiple or a perpetual growth model? What should the assumed multiple or growth rate be?

The asset approach to valuation reflects the adjusted cost and/or liquidation value of the individual assets of an entity. Accordingly, it is often perceived as not being an accurate measure of true worth or otherwise that helpful for companies that are going concerns. While often leading to a number that is considerably lower than figures derived from the market or income approaches for thriving businesses, it may be more instructive and a useful cross-check for a distressed company.

Valuation of a Reorganizing Debtor

As was recognized by the U.S. Supreme Court's opinion in the *Consolidated Rock* case[3] — which since 1941 has been cited and followed by literally hundreds of other court opinions in bankruptcy cases — the core question to be addressed in valuing a company that proposes to reorganize and emerge from a bankruptcy case is its "earning capacity."[4] This must be so "if the enterprise is to be freed from the heavy hand of past errors, miscalculations or disaster."[5]

In other words, the appropriate approach is not to assess the worth of the company as it has arrived or while it is in Chapter 11, but should be an attempt to take into account the company's future prospects.[6]

The income or DCF approach by definition is forward-looking. But management's projections of the future may be overly optimistic or fail to take into account that the company starts with some disadvantages to its peers from the mere fact that it has been troubled and in bankruptcy. It may be some time after it emerges from Chapter 11 before a company regains its full competitive bearings and manages to reduce its risk profile.

Accordingly, some courts have allowed experts to incorporate an "emergence premium" or a "company-specific risk premium" into the discount rate they use in calculating the present value of the company's projected future cash flows.[7]

The comparable company and comparable transaction analyses that are constituents of the market approach to value are typically retrospective or backward-looking in nature. They often compare the revenues, EBIT, and/or EBITDA of a company during the last reported 12 months to such figures for similar firms that have a market-determined or transaction-indicated value to estimate the worth of the subject firm. This approach is much less problematic when applied to healthy companies rather than those in Chapter 11.

If the main reason for a company's Chapter 11 is that it has recently piled up too much funded debt and become overleveraged, then perhaps the use of historical performance figures in the market approach may achieve a decent approximation of the company's worth, so long as there is an adjustment for the costs of the company's reorganization (such as the fees of professionals and other extraordinary expenses related to the Chapter 11 case). Such costs are taken into account in the acronym EBITDAR, in which the "R" stands for restructuring costs.

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Figure 1: Valuation Methodology Overview

	MARKET		INCOME	ASSET	
Methodology	Comparable Public Company	Comparable M&A Transaction	Discounted Cash Flow	Forced Sale	Orderly Liquidation Value
Key Factors	• Choice of company set • Multiple • Timeframe (historical vs. forward) • Size, mix of products/services, customers, other comparison items	• Choice of transaction set • Multiple • Length of timeframe • Size, mix of products/services, customers, other comparison items	• Projected cash flows • Cost of Capital • Risk Premiums • Terminal value	• Proceeds expected from an auction or other time-limited disposition of assets, typically piecemeal (*e.g.,* Article 9 or foreclosure sale)	• Prices expected for individual or aggregated assets from reasonable marketing and sale efforts over an appropriate period of time

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In contrast to mere financial restructuring while in Chapter 11, financial history will obviously not be a good guide for a company that is undertaking a significant alteration of or reduction in its assets, or a variety of changes or improvements in its operations. In other words, management's projected EBITDAR for the company, after asset adjustments and operational improvements have been accomplished, would be a more accurate basis for measuring a company's worth upon exiting bankruptcy.

Thus, in the application of the comparable company and comparable transaction analyses to the Chapter 11 company before it, the court in *Exide Technologies* recognized that those analyses should reflect the "benefit of the [company]'s restructuring," and that "it is appropriate to use projected, rather than historic, EBITDAR."[8]

Sum-of-the-Assets Cross-Check

Application of the asset approach to assessing the worth of a company may be a useful and revealing cross-check on the market and income approaches to value, particularly when the company is in Chapter 11 and also is at the bottom of an industry cycle or in an economic downturn (*i.e.,* double trouble). The company's deteriorated financial performance within bad industry or economic circumstances can cause the inputs for the market and income approaches (multiples of recent financial performance and anticipated cash flows discounted to the present) to become unreliable and to underestimate value.

Capital-intensive or "asset-rich" companies in such situations very well may be worth more dead than alive. That is, the asset approach could reveal that the aggregate proceeds that could be realized from its assets in an orderly liquidation or even a forced sale exceed the company's value as a going concern when measured at present by other approaches to value.

This dynamic has been at work for the past few years among distressed suppliers in the automotive industry. The final price for several such companies being sold in Chapter 11 as going concerns has been most reflective of the aggregated worth of their individual assets, with the successful purchaser acquiring a company for an amount perhaps only a little more than the orderly liquidation value of its assets.

Figure 2: Conflicting Incentives in Valuation of a Reorganizing Chapter 11 Debtor

Senior Debt	Unsecured Debt	Equity Holders	Management
Undervalue	Overvalue	Overvalue	Undervalue
More likelihood of obraining equity or warrants	More recovery on claims and/or equity participation	Preservation of old equity as much as possible	Increased share in equity through management incentive plan

In considering what might be the best value for a troubled automotive supplier's assets in a Chapter 11 case, parties have become accustomed to considering the worth of the debtor's assets if sold individually or in groupings that might be desired by prospective purchasers or realized upon by secured creditors.

> At a minimum, whether a company is going to attempt to sell or reorganize around itself, the asset value of the company should serve as a floor below which a sale price or the value tied to its reorganization plan should not fall.

For instance, a line of machinery could solve another party's need to expand business with a new or existing customer. Or, as another example, the supplier's primary secured creditor, if given relief from the automatic stay (and if setoffs by the company's customers were prohibited under pre-existing agreements), might be able to collect substantial sums from the company's accounts receivable.

At a minimum, whether a company is going to attempt to sell or reorganize around itself, the asset value of the company should serve as a floor below which a sale price or the value tied to its reorganization plan should not fall.

Conflicting Incentives

As the court observed in the recent *Granite Broadcasting* case, "valuation of a debtor in connection with confirmation of a plan is at best a challenging undertaking."[9] But the challenge for Bankruptcy Courts in arriving at an appropriate valuation in contested proceedings may not end with the "triple trouble" of the inexactitude of valuation methodologies, the complexities of a troubled company in Chapter 11, and the extra problems resulting from adverse industry or economic trends.

While conflicting incentives of the parties in a contested valuation is not unique to the bankruptcy context, scholars have observed that various parties involved in a Chapter 11 case have underlying motives and take positions that tend to overvalue or undervalue a reorganizing entity.[10] According to this research, senior secured creditors, general unsecured creditors, equity holders, and company managers each may lean toward a view on value that would tend to enhance their actual or potential stake in the reorganized entity (**Figure 2**).

In determining — and therefore allocating — reorganization value, courts are mindful of these conflicts among the classes of claims and equity interests, and their opinions reflect their scrutiny for adjustments that may be necessary or appropriate within various experts' analyses and reports.[11]

For example, in the *Exide Technologies* case the Bankruptcy Court preferred what it viewed as the more objective approach of the unsecured creditors' committee's expert over the subjective adjustments used by the debtor's expert. This was true even though the debtor's expert was at least attempting to take into account the quality and level of purchase offers that had been received in a marketing and sale process that had been attempted prior to the company's Chapter 11 case.[12]

In contrast, all three professionals who conducted valuations of the reorganized debtor in the *Bush Industries*[13] case recognized that there was a lack of truly comparable company information because the debtor was the only public company in the ready-to-assemble segment of the furniture industry. Therefore, they each turned to data available about manufacturers of other types of furniture.

Because those manufacturers apparently were less impacted by problems facing the debtor's industry segment, two of the experts

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made adjustments to arrive at an indicated reorganization value for the debtor, while the equity committee's expert did not. In dismissing the equity committee's argument that its expert was more "objective" in his analysis, the court reasoned that, under the circumstances, "[a] decision to make an adjustment is just as subjective as any decision about the magnitude of an adjustment."[14]

Ultimate Value Indicator

In certain circumstances, cutting across the traditional approaches to valuation is the reality check of whether a capable and involved party is willing to make and follow through on an offer that exceeds a valuation figure it asserts is too low. This was the situation in the *Granite Broadcasting* case.

As has been occurring more frequently with distressed companies that resort to Chapter 11, certain hedge funds had replaced a majority of the original holders of both the senior secured debt and the preferred equity of the debtors prior to the petition date. Thus, both of these classes were represented by sophisticated and well informed parties with ample and readily available funding to support and protect their respective positions.[15]

A plan was proposed by management that allocated the new equity in the reorganized enterprise to the holders of the senior debt and provided nothing for the holders of the preferred equity. On the issue of whether the plan was "fair and equitable" and could be confirmed, the preferred equity holders asserted that the plan undervalued the reorganized debtors, provided the senior debt holders "with a recovery in excess of their allowed claims," and in effect prevented the preferred equity holders from retaining a stake in the reorganized company in the form of new equity.[16]

On "the premise that an offer made by a willing buyer to a willing seller in an arms-length transaction is the best indication of value,"[17] the Bankruptcy Court gave the preferred equity holders "an opportunity to make an offer to purchase the debtors or fund an alternative plan of reorganization that would establish value in the [reorganized enterprise] beyond the debt [owed to senior creditors]."[18]

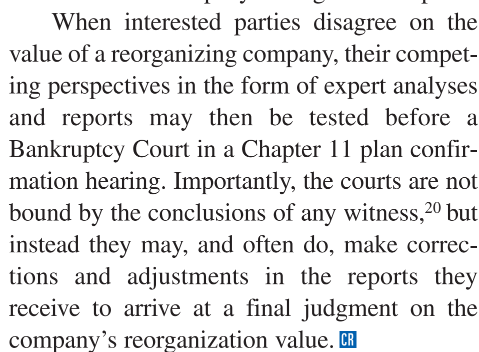
The preferred equity holders conceded that they had enough cash or credit to purchase the enterprise and that they were informed and motivated purchasers. In fact, they submitted multiple and revised offers to fund an alternative reorganization plan.

> The process of valuation is obviously imprecise, as it involves the use, modification, and melding of different methodologies and the necessary application of professional judgment.

However, the court determined that the best offer of the preferred holders in the end did not completely satisfy the claims that were senior to them, and therefore their offer did not justify their goal of retaining an interest in the reorganized enterprise in the form of new equity. The court thus confirmed the debtors' proposed plan, which was also supported by credible valuation testimony indicating that the reorganized debtor's value did not exceed the total claims of the senior creditors.[19]

Complicated Process

The process of valuation is obviously imprecise, as it involves the use, modification, and melding of different methodologies and the necessary application of professional judgment. That process is certainly more complicated when the subject company is in Chapter 11 and facing an industry downtrend or general economic turmoil and the valuation is supposed to reflect the worth of the company as of the effective date of the company's reorganization plan.



When interested parties disagree on the value of a reorganizing company, their competing perspectives in the form of expert analyses and reports may then be tested before a Bankruptcy Court in a Chapter 11 plan confirmation hearing. Importantly, the courts are not bound by the conclusions of any witness,[20] but instead they may, and often do, make corrections and adjustments in the reports they receive to arrive at a final judgment on the company's reorganization value. CR

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1 See 11 U.S.C. Section 547(f).

2 This is often referred to as the weighted average cost of capital (WACC).

3 *Consolidated Rock Products Co. v. Du Bois*, 312 U.S. 510, 61 S. Ct. 675, 85 L. Ed. 982 (1941).

4 *Id.*, 312 U.S. at 526.

5 *Id.*

6 See, *e.g.*, *In re Nellson Nutraceutical, Inc.*, 2007 Bankr. LEXIS 99 (Bankr. D. Del. 2007); *In re Exide Technologies, et al.*, 303 B.R. 48 (Bankr. D. Del. 2003).

7 See, *e.g.*, *Nellson Nutraceutical, supra*, at 76-77.

8 *Exide Technologies, supra*, 303 B.R. at 62.

9 *In re Granite Broadcasting Corp., et al.*, 303 B.R. 120, 140 (Bankr. S.D.N.Y. 2007).

10 See Stuart C. Gilson, Edith S. Hotchkiss & Richard S. Ruback, *Valuation of Bankrupt Firms*, 13-1 REV. OF FIN. STUD. 43 (2000).

11 See, *e.g.*, *In re Coram Healthcare Corp.*, 315 B.R. 321, 339 (Bankr. D. Del. 2004).

12 *Exide Technologies, supra*, 303 B.R. at 66.

13 *In re Bush Industries, Inc.*, 315 B.R. 292 (Bankr. W.D.N.Y. 2004).

14 *Id.* at 302.

15 *Granite Broadcasting, supra,* 303 B.R. at 130-31, 143.

16 *Id.* at 140.

17 *Id.* at 128.

18 *Id.* at 143.

19 The court also saw problems with the "conditionality" and "feasibility" of the preferred equity holders' proposal. *Id.* at 145-46.

20 *Nellson Nutraceutical, supra,* at 63.

David Powlen is a managing director and partner with the investment banking firm Western Reserve Partners and leads the firm's restructurings, special situations, and Chapter 11 services. *The author would like to thank Mark Filippell, another managing director and partner with Western Reserve Partners, for his helpful comments on this article. In addition, the author gratefully acknowledges assistance from Kyle Napierkowski, a candidate to receive both a bachelor's degree in business management and a master's degree in finance from Case Western Reserve University 2009, in the preparation of this article.*

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