



KEY VALUATION ISSUES IN DISTRESSED INVESTING

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The distressed investor considers investing in securities of companies that are either in bankruptcy or are approaching bankruptcy. Typically, these companies have outstanding claims greater than the value of the assets and are experiencing difficulty in servicing their debt. There is a real possibility that the company will be liquidated or will be reorganized as a going concern.

The investor may be looking to acquire distressed debt or other securities in the hope that these securities will either increase in value following a liquidation or reorganization, or convert to equity ownership. These two possible outcomes, liquidation or reorganization, require different valuation methods to calculate. However, there are many uncertainties that the investor needs to consider.

The definition of a distressed company varies. For example, some regard a company as distressed if the yield-to-maturity on its bonds is more than 1,000 basis points greater than the risk-free rate. Other sources consider companies rated at CCC or below as distressed. According to Standard & Poor's, "[a]n obligation rated 'CCC' is currently vulnerable to nonpayment and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitments on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitments on the obligation." Independent of the definition of a distressed investment, numerous valuation implications exist.

To approve the plan of reorganization, the Bankruptcy Court must be convinced that post-reorganization the company is expected to be a viable, going concern entity, *i.e.*, the company is expected to operate in the foreseeable future. This may be performed by comparing

the value of the assets (commonly referred to as "business enterprise value") of the company to its debts.

One of the most basic methods of valuing a company is to add up the book value of the assets and subtract the book value of the liabilities. However, the result can be highly misleading, as the assets were recorded at their original cost, which may have no correlation with the fair market value of those assets. For example, the value of the property, plant, and equipment may be understated, as the replacement cost may be far higher than the original cost. Furthermore, estimates of depreciation would have reduced the asset values on the balance sheet. Inventory, which is valued at the lower of cost or market value may also not accurately reflect the true worth of the asset. On the other side of the balance sheet, the book value of the liabilities fails to record off balance sheet liabilities that should be taken into account when valuing a company.

The authors typically value a going concern entity based on an income or market approach and not on book values.¹ The income approach looks into the future at the cash flows expected to be generated by the company and calculates the present value of these future cash flows. The market approach compares the value of comparable companies or comparable M&A transactions to the subject company.

Naturally, the valuation of relatively healthy companies involves many unknowns and uncertainties, including:

- The viability of the company's product
- Relationships with vendors
- The price of key raw materials
- The company's future market share

- Unfunded pension liabilities
- Regulatory changes
- Economywide factors

However, the valuation of distressed companies includes numerous additional elements of uncertainty as well. Examples include:

- The ability to retain employees
- The ability to reorganize
- The structure of the reorganized entity
- The ability to divest underperforming assets
- Litigation risk resulting from the company's distress
- Access to capital markets post-reorganization
- Cost of funds post-reorganization
- The possibility that the company may be liquidated

The uncertainty resulting from the distress impacts all three commonly used valuation methodologies. Several factors relating to the valuation of distressed companies as going concerns are discussed in the remainder of this article.

Guideline Public Company Method

This approach (also referred to as CompCo) determines a company's value based on selected multiples of comparable publicly traded companies. The authors identify companies that are in a similar business to the subject company's and compute multiples such as price-earnings or enterprise value-to-EBITDA for these companies. These multiples are then multiplied by the subject company's earnings or EBITDA to arrive at a value.

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Projections used in DCF analyses are inherently uncertain. For a distressed company, there is even more uncertainty. If the distress is due to industrywide issues, forecasting is even more difficult.

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Multiples may be calculated on historical or projected results. Multiples based on projected results are referred to as forward multiples. For a distressed company, historical results are less relevant than projected results, especially when the valuation assumes that the company will be reorganized. However, when using forward multiples

of comparable companies, the investor must rely on uncertain projections. Also, analyst consensus estimates may not be available for the comparable companies if they are not widely covered or if the analysts have stopped providing estimates because the comparable companies are also distressed.

Often, a company may be distressed when the entire industry is also in distress. For example, during the

financial crisis of 2008, many real estate developers were in a similar state of distress. At the time, these developers' earnings and EBITDA were unusually low or negative. Multiples are calculated with earnings or EBITDA in the denominator. Therefore, if these figures are negative, the calculated multiples are not meaningful. Similarly, if these figures are unusually low, the calculated multiples will be unusually high and also may not be meaningful. In these



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cases, it may be more meaningful to move up the income statement and calculate multiples based on revenue.²

Once calculated for the comparable companies, this multiple needs to be applied to the subject company. Analysis is required to determine if the subject company is a median (midrange, typical) company, or performs better or worse than the comparable companies. However, when the entire industry is distressed, as real estate developers were in 2008, such analysis is difficult to perform. One element not reflected in the multiples is the expected growth rate. When companies are healthy and are expected to grow at a higher rate than the industry as a whole, the authors may choose to use a multiple higher than the median (e.g., upper quartile).

For a distressed company, forward multiples carry a higher degree of uncertainty. In addition, often the return to profitability is not instantaneous. If the turnaround is expected to take a long time, forward multiples for the comparable companies may not be available.

Many years ago, the authors worked on the bankruptcy of Hechinger, a chain of home improvement stores headquartered in Maryland. In the late 1990s, its two largest competitors, Home Depot and Lowes, were expanding rapidly, with Home Depot alone spending more than \$1 billion and opening more than 100 stores per year. Many smaller competitors could not compete and were losing money. Selecting comparable companies for valuation was particularly challenging, as Hechinger was not comparable to Home Depot and Lowes, and the smaller companies were losing money, and therefore their multiples were negative and thus not economically meaningful.

Guideline Merged and Acquired Company Method

This methodology (also referred to as CompM&A) examines M&A transactions. It determines a firm's value based on selected multiples of comparable target companies that were acquired in M&A transactions.

The definition of fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge

of relevant facts. If an industry is distressed, M&A values may not reflect fair market values, as the selling party might be under compulsion to sell.

For example, the authors were asked to value a European sporting goods manufacturer that was involved in litigation regarding its value at the time of the sale of its business. The founder had died and his wife inherited the company. She had no interest in running the business. Moreover, she was concerned about the value deteriorating due to her lack of knowledge of the business. She eventually sold the company at a low value. In a dispute relating to the value of this company, a jury decided that her compulsion to sell was a significant factor, and therefore, the fair market value was higher than the transaction price.

Discounted Cash Flow Method

The discounted cash flow (DCF) valuation is a standard framework used to value a business. It is a member of a set of valuation methodologies referred to as the income approach. This process estimates a stream of cash flows into the future and then discounts the stream by the discount rate back to the valuation date. A terminal value is calculated, which accounts for the periods extending beyond the time horizon that was projected in detail.

As mentioned earlier, the Bankruptcy Court will approve a plan of reorganization only if the company is expected to be a viable going concern. Projections used in DCF analyses are inherently uncertain. For a distressed company, there is even more uncertainty. If the distress is due to industrywide issues, forecasting is even more difficult. The authors often find that management or financial advisors have projected a recovery post-reorganization. This recovery usually follows a prolonged period of deterioration and may resemble a hockey stick, which often attracts increased scrutiny.

The projections require a number of assumptions, the outcome of which is highly uncertain. For example, one needs to consider whether there will be any divestitures of business segments, headcount reductions, store closures, catch-up payments for unfunded pension liabilities, reductions in capital expenditures, and many more factors. An analysis of the

projections typically includes a test of the reasonableness of the assumptions.

Once the cash flows have been determined, they are discounted to the present value using a discount rate. The discount rate most frequently used to discount the debt-free cash flows is the weighted average cost of capital. As the name describes, this is a weighting of the costs of the different sources of capital: debt and equity.

The cost of debt is usually relatively simple to determine in a healthy company. For a distressed company, the cost of debt is usually high. Post-reorganization, there is uncertainty as to the cost of the restructured debt, which is based on the uncertain amount of debt. To reduce the probability of the company filing for bankruptcy protection a second time, Bankruptcy Courts would only approve a reasonable level of debt that the company would be able to service. Therefore, the cost of debt is often based on a non-distressed reorganized company post-emergence rather than the distressed company pre-Chapter 11. DIP financing should not be used to determine the cost of debt, as DIP financing has a higher priority over other classes of debt, which typically results in a lower cost of debt.

The cost of equity is the return necessary to compensate investors for all of the risks associated with ownership. The cost of equity is calculated using the capital asset pricing model (CAPM). The CAPM includes a measure of a company's systematic risk (referred to as "beta"), or tendency to move relative to the market, and the risk-free rate. The systematic risk is determined using a regression between the rate of return on the company's stock and the return on the overall market. However, given that a distressed company has its own life and thus is uncorrelated with the market, the regression results may not be meaningful, and therefore the beta estimated during the period of distress cannot be relied upon.

Sometimes circumstances warrant adding a risk premium to the cost of equity based on the size of the company, as empirical research indicates that the required rate of return by investors on small companies is higher than on larger companies. The determination of the size premium is

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complicated by the fact that investors investing before a plan of reorganization do not know the size of the company post-reorganization. The investor also needs to carefully consider whether it is appropriate to add a distress component to the cost of equity, as post-emergence, the company is not expected to be distressed.

Included in the projections is an estimate for taxation. While the tax rate is usually known, the company may have a large net operating loss (NOL). Under certain circumstances, NOLs can be carried back two years and carried forward 20 years to offset taxable income incurred in those years. An assessment must be made as to how the NOL will be used in the future. As the NOL provides a tax shield in the future, there is value to it. This value is based on the amounts and timing of the tax savings that the company will realize as a result of the NOL.

The final component of the DCF is the calculation of the terminal value. Once the company is projected to reach a steady state of cash flows, an assumption must be made as to the rate at which these cash flows would continue to grow, in perpetuity. As the reorganized company may bear little resemblance to the distressed company, the determination of the growth rate is difficult.

Judicial Preference

While all three valuation methods are frequently applied, many courts prefer the DCF method. For a reorganized company, it is uncommon to value the company using only the guideline public company approach or the guideline merged and acquired company approach without also performing a DCF. As discussed, however, all three valuation methodologies have added challenges when applied to distressed companies beyond the issues ordinarily faced when valuing a healthy company. ■



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¹ An adjusted balance sheet approach may be used where the value of assets and liabilities are readily available.

² As revenue is the top line of the income statement, relying on it for calculating multiples has its own limitations.