

FUNDAMENTALS OF VALUATION ANALYSIS, PART III: TESTING THE MODELS IN CASE DECISIONS AND OTHER SCENARIOS

Presented By:

Albert S. Conly, FTI Consulting, Dallas, TX

Peter M. Gilhuly, Latham & Watkins LLP, Los Angeles, CA

James R. Latimer, Blackhill Partners, Dallas, TX

Frank A. Merola, Stroock & Stroock & Lavan, LLP, Los Angeles, CA

William L. Wallander, Vinson & Elkins LLP, Dallas, TX

Nothing in this presentation is to be considered as the rendering of legal advice for specific transactions or litigation. This presentation is intended for education and information purposes only.

Overview of Valuation Methodologies

V&E

- Discounted Cash Flow (“DCF”)
- Comparable Companies
- Precedent Transactions
- Market Capitalization

- Based on the present value rule:
 - the value of any asset is the discounted present value of all of its expected future cash flows.
- Estimates the intrinsic value of an asset by projecting the expected cash flows and attaching a discount rate to each cash flow.
- There can be a substantial amount of uncertainty surrounding the projection of an asset's cash flows into the future and the selection of an appropriate discount rate, each of which often leads to disputes and battles of the experts.

Comparable Companies

V&E

- Used to determine the value of a company by using the economic metrics of other similar companies that are in the same industry, are similar in size, and are generally exposed to similar risks.
- Operates under the assumption that similar companies will have relatively similar valuation multiples.
- The multiples of comparable companies are applied to the target company's economic metrics to determine its value.
- Public companies are often used because their economic data is readily available.
- If the sample set is comprised of companies that lack a sufficient similarity to the target company, that expert's valuation may be dismissed as unreliable.
- Experts consider such factors as company size, industry, geographic region, leverage, profit margins, and growth patterns.

Precedent Transactions

- Based on recent transactions involving companies that are similar to the target company.
- Valuation experts focus on finding transactions that involve companies that are similar to the target company in terms of business sector, geographic region, and size.
- Like the Comparable Companies analysis, the sale price of the similar company is viewed as a multiple of an appropriate economic metric.
- The target company's value is then determined by applying the resulting multiple to the same economic metric of the target company.
- The greater the congruence between the Precedent Transaction sample set and the target company, the more confidence placed in the valuation.

- Some courts have begun to utilize a target company's securities' trading price to inform the valuation process.
- Premised on the efficient market hypothesis which is the hypothesis that, if given adequate information, the public markets will tend to value a company more accurately than those valuations gleaned from a valuation model premised on assumptions of future cash flows and comparisons with other companies.
- Courts will consider either:
 - the market capitalization of the target company's outstanding equity, or
 - the combined market value of the target company's publicly traded debt and equity.

Key Current Trends in Bankruptcy Valuation

V&E

- Market capitalization and macro-economic market conditions are increasingly considered by courts in connection with review of valuations.
- Courts have adjusted management created cash flow projections when experts provide reasonable explanations why such projections require adjustment.
- Courts and experts utilize multiple valuation methods to arrive at a valuation range, and often times these different valuation methodologies will be weighted in accordance with the particular nuances of the target company.

Market Influence on Valuation- *In re Exide Techs.*, 303 B.R. 48 (Bankr. D. Del. 2003)

- The court held that because markets tend to undervalue entities in bankruptcy, the application of a “market-based” discount is inappropriate for plan confirmation and valuation purposes.
- Because the court had rejected the debtor’s “market-based” discount approach, it adopted the creditors’ committee’s terminal value exit multiple and discount rate for its DCF.
- The debtor had also utilized an unorthodox method of determining the discount rate, without using the Capital Asset Pricing Model, which the court dismissed because it had been subjectively modified to yield an advantageous valuation.

Market Influence on Valuation-

V&E

In re Mirant Corp., 334 B.R. 800 (Bankr. N.D. Tex. 2005)

- The court noted that the taint of a bankruptcy may reduce the usefulness of post-petition trading prices of a bankrupt debtor's publicly traded securities as an indication of value.
- The court also discussed the “inherent subjectivity” in valuation and the potentially “perverse incentive structure” created by parties paying their valuation professionals based on getting the “right” valuation.

Market Influence on Valuation-

In re VFB LLC v. Campbell Soup Co., 482 F.3d 624 (3d Cir. 2007)

- Issue was whether the debtor received reasonably equivalent value in exchange for the money it paid to purchase a company's division.
- The district court found that the debtor had received reasonably equivalent value based on the significantly positive market capitalization of the division immediately post spin-off.
- The debtor appealed, making the argument that market capitalization was not an accurate indication of the value of this company because the seller manipulated the subsidiary's sales and earnings prior to the spin-off.
- The Third Circuit upheld the district court's ruling, validating the district court's use of market data for valuation purposes, and explained that that "[a]bsent some reason to distrust it, the market price is a more reliable measure of the stock's value than the subjective estimates of one or two expert witnesses."

Market Influence on Valuation-

In re Iridium Operating LLC, 373 B.R. 283 (Bankr. S.D.N.Y. 2007)

- The creditors' committee brought a fraudulent transfer action to avoid Iridium's spin-off of assets, arguing that the spin-off rendered Iridium insolvent.
- Utilizing a Market Capitalization approach, Motorola persuaded the court that Iridium was solvent immediately post spin-off by using such market factors as: (i) the debtor's ability to obtain financing post spin-off, and (ii) the debtor's positive equity valuation measured by its market capitalization immediately post spin-off.
- The court explained that "the public trading market constitutes an impartial gauge of investor confidence and remains the best and most unbiased measure of fair market value and, when available to the court, is the preferred standard of valuation."
- The court then further stated that it is "not bound to accept the value that has been ascribed to [the debtor's] securities by the public markets and has the broad discretion to find that the markets somehow were distorted and did not fairly reflect the underlying enterprise value of [the debtor]."
- The court held that to justify the disregarding of market values of a company's publicly traded securities in an efficient market, the court would need "a substantial reason to depart from that standard and find that the value implied by an efficient market is not a trustworthy benchmark."

Market Influence on Valuation-

In re TOUSA, Inc., 422 B.R. 783 (Bankr. S.D. Fla. 2009)

- TOUSA borrowed \$500 million and caused two of its formerly unencumbered subsidiaries to become obligated for the new debt.
- The creditors' committee brought an action to avoid the liens relating to this new debt as preferential or a fraudulent transfer.
- The creditors' committee's expert relied on a Market Capitalization approach that utilized market values of the publicly traded debtor's debt and equity.
- The court agreed and explained "The sum of the market values of a company's debt and equity is the textbook definition of enterprise value...[I]t is commonly accepted among valuation professionals...[T]he market price of the equity plus the market price of the debt is what it would cost investors to purchase claims on all of the company's assets."
- The court rejected the lenders' assertions that the market was inefficient and cited the following as evidence of market efficiency: (i) the SEC allowed TOUSA to file an S-3 short form registration, and (ii) the debt and equity of TOUSA were actively traded.

Adjusting Management Projections-

In re Nellson Neutraceutical, Inc., 2007 WL 201134

(Bankr. D. Del. 2007)

- The court downwardly adjusted management's cash flow projections when it discovered that the projections were probably manipulated to yield a valuation putting old equity holders in the money.
- All of the valuation experts had relied on the debtors' long-range business plan to formulate their valuation opinions, but the evidence at trial "overwhelmingly established that the [long-range business plan] was not management's best and most honest thinking about the debtors' financial future but rather was manipulated at the direction of and in cooperation with the debtors' controlling shareholder to bolster the perceived value of the debtors' business solely for purposes of this litigation."
- After considering the creditors' expert's opinions, the court made an adjustment to the valuation to compensate for the long-range business plan and the debtors' deteriorating business and concluded that the debtors' enterprise value put equity holders out of the money.

Adjusting Management Projections-

In re Chemtura Corp, 439 B.R. 561 (Bankr. S.D.N.Y. 2010)

- The equity committee's expert submitted a DCF only valuation that was subject to aggressive projections under the management created long range plan.
- The court found the management prepared projections (which assumed that a general macroeconomic recovery to pre-recessionary levels would occur in 2011, which would result in further earnings improvements through 2014) to be overly aggressive. The projections called for unprecedented levels of performance for the business for years after 2011 in the wake of a major financial recession.
- The court explained that "I can and do find that since the Debtors' Long Range Plan is already aggressive, and since the speed (and in the views of some, the fact) of the economic recovery is uncertain, it is inappropriate to be as confident as the equity committee is as to future growth in the American economy and increasing Chemtura EBITDA growth."
- The equity committee's model solely relied on the overly aggressive cash flow projections as the basis for determining terminal value.
- The court held that the final cash flow should have been downwardly adjusted to account for the overly aggressive assumptions and the business's cyclicity.

Adjusting Management Projections- *In re PTL Holdings LLC*, 2011 WL 5509031 (Bankr. D. Del. 2011)

- The court held that the management prepared cash flow projections were credible despite a challenge that: (i) the projections were unreasonably pessimistic in terms of economic growth and the business's own performance, and (ii) the projections purposefully undervalued the company so as to maximize the post-confirmation upside of their equity interests.
- The court found the challenge to the cash flow projections to be insufficient and that the management produced cash flow projections were credible.
- Relying on these projections, the debtor's expert prepared valuations using the three standard valuation methods.
- The court agreed with the debtor's valuation and found "that the debtors have carried their burden to demonstrate that the total enterprise value of the debtors' business is insufficient to provide for a recovery to the second lien secured creditor."

Adjusting Management Projections-

In re Spansion, Inc., 426 B.R. 114 (Bankr. D. Del. 2010)

- The court accepted an expert's consideration of a "contingency case" of projected cash flows which downwardly adjusted the management prepared cash flows to account for foreseeable down sides that would affect the debtor's business.
- Each party relied on a weighted average of the traditional three valuation methods to get a valuation range.
- The debtors and the senior noteholders prepared two types of financial projections, one base case which represented management's best estimate of the debtors' future performance over the following period, and another contingency case which took into consideration certain foreseeable downsides that could negatively impact the debtor's business.
- The court agreed that both the base case and contingency case projections should have been considered and found that, in light of the valuation, the plan treated Class 5C (the dissenting convertible noteholders) "fairly and equitably."

Using Multiple Valuation Methods-

In re DBSD n. Am. Inc., 419 B.R. 179 (Bankr. S.D.N.Y. 2009)

- Experts each utilized a weighted average of the three traditional valuation methods, but relied on differing weights and underlying assumptions for each model.
- The court rejected the DCF model because:
 - The nature of the debtor's business situation made the assumptions unreasonable. The debtor's business involved the development of technology which was not yet in operation.
 - The DCF analysis relied on projected cash flows that required capital expenditures which the court found the debtor would probably be unable to make.
 - The debtor's DCF analysis was also based on a stream of "consistently negative cash flows." The court held that a cash flow projection that included a few negative cash flow years could work, but a DCF valuation cannot be based on a stream of entirely negative cash flows.
- The court held that the Comparable Companies analysis was the most reliable, in large part because it resulted in the smallest discrepancy between the opposing experts.
- The court also found that the valuation that relied on both market and book values (instead of only the market value) was superior because stock in the comparable companies was trading at a "discount at the time of valuation, and because of the uncertainty in the markets, it was prudent to weight the book and market value equally."
- The Court found the two Precedent Transactions analyses to be unreliable, one for reasons of not enough comparable companies and the other for too broad of a range of valuations.
- The court ultimately found that the creditor was fully secured and, because of the immense disparity between liquidation value and going concern value of the debtor, no creditor would receive more in a liquidation than under the plan.
- The court also found that the plan was feasible because not only was there a de minimus risk of default, but the creditor was over-secured by about seven times the value of its claims.

Using Multiple Valuation Methods-

ASARCO LLC v. Ams. Mining Corp., 396 B.R. 278 (S.D. Tex. 2008)

- Plaintiffs alleged that a transfer of a subsidiary's stock in a Peruvian mining company was a fraudulent transfer.
- The court held that stock price valuation and DCF were more appropriate indicators of fair value than the market multiples approaches.
- The court noted that, at the time of the transfer, the subsidiary's stock was traded on an extremely reliable exchange and was followed by a number of securities analysts. However, due to the low weekly trading volume and low public float of the stock, the court emphasized that it did not rest its entire reasonably equivalent value analysis on the stock price valuation method.
- The court found that in an arms-length transaction a willing buyer would have paid a willing seller a premium on top of the stock price to acquire a controlling interest in the subsidiary, and the court determined that a 20% control premium was appropriate.
- The court held that the Comparable Companies and Precedent Transactions methods were the least reliable methods for this case. The court highlighted the fact that the Precedent Transactions method produced results ranging from \$257 million to over \$1 billion. However, the court acknowledged the value of conducting these tests as reasonableness checks.
- The court held that the DCF method was the most reliable means of valuing this subsidiary's stock and denied the plaintiffs' constructive fraudulent transfer claim on the grounds that the amount the debtor received for its subsidiary's stock was not unreasonably less than the stock's fair value.

Market Influence on Valuation-

U.S. Bank N.A. v. Verizon Comm. Inc., No.10-01842, (N.D. Tex. Jan. 22, 2013)...Idearc.

- Verizon spun off its print and internet yellow pages company into a new publicly traded entity called Idearc, Inc. (“Idearc”). Pursuant to the spin-off, Idearc transferred nearly \$2.5 billion in cash, much of it raised from bondholders, to Verizon Financial Services and took on \$9 billion in debt in excess of assets.
- Litigation trustee brought fraudulent transfer claims against Verizon.
- The court disagreed with the Trustee’s expert’s rejection of market evidence to inform her valuation of Idearc. The Trustee’s expert argued that market participants had over-valued Idearc because of various misrepresentations and omissions made by Verizon. The court disagreed with these assertions and held that the market’s valuation of Idearc was reliable.
- The court also rejected the Trustee’s expert’s heavy reliance on a DCF analysis that yielded a significantly lower valuation than the other methodologies (Comparable Companies and Precedent Transactions). Relying on the market’s valuation of Idearc securities and the other valuation methodologies, the court concluded that Idearc was solvent at the time of the spin-off.

FUNDAMENTALS OF VALUATION ANALYSIS, PART III

V&E

Q&A