

AMERICAN BANKRUPTCY INSTITUTE **JOURNAL**

October 2020 • Vol. XXXIX, No. 10

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Value & Cents

BY DANIEL R. VAN VLEET

Bankruptcy and Business Valuation in the Current Environment



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Even in the best of times, the valuation of a company involved in a bankruptcy can present its own set of challenges. In the current environment, those challenges have been magnified. COVID-19 has fundamentally altered the social, financial and economic fabric of our society. Stay-at-home orders, social distancing, high unemployment, remote business operations, civil disorder, urban flight and the classification of essential vs. non-essential businesses has impacted different sectors of the economy in material and disparate ways. As one might expect, these changes have also affected the way that business valuations are conducted.

The income and market approaches are business-valuation approaches that are often used in bankruptcy matters to determine solvency/insolvency and plan feasibility. Given the current environment, the mechanical application of these approaches might produce indications of value that lack credibility and reliability. This article will address valuation issues associated with the current environment and provide suggested modifications to the traditional application of business-valuation approaches.

Income Approach

The income approach is based on projections of financial performance and the cost of capital of a subject company. From these projections, estimates of expected cash flows are developed and converted into an indication of value using a discount rate based on an appropriate cost of capital. One of the primary components of the income approach is the projected financial performance of the subject company.

Projected Financial Performance

When preparing the projections for the subject company, an assessment should be made to deter-

mine whether the current environment conditions will impact the subject company on a temporary or more permanent basis. If temporary, the following issues should be addressed in the analysis:

- the length of time of the temporary period and the cash-flow requirements for the subject company to return to normalized financial and operational performance;
- new cost structure of the business during the temporary period related to regulatory issues, financial performance and operational changes;
- temporary cash-flow impact of existing obligations, government loans, stimulus payments, the Payroll Protection Plan, debtor-in-possession financing, cash infusions and other forms of support; and
- the impact of depreciation, capital expenditures and incremental working capital on the projected cash-flow performance during the temporary period.

If the impact on the subject company is more permanent in nature, the projections should still reflect these aforementioned issues. However, the analysis should also reflect the reality that there will be no return to normalized business operations. When this is the case, the “new normal” conditions are projected to continue for the foreseeable future.

In addition to these issues, the current environment has created significant new challenges that must be addressed when estimating the discount rate used in the income approach. The discount rate can have a material impact on a company's valuation.

The Discount Rate

The discount rate is calculated based on the estimated costs of debt and equity capital for the subject company. The cost of equity capital is typically calculated by adding the market yield of U.S. Treasury

securities to an equity risk premium derived from publicly traded companies. This calculation can become problematic when a “flight to quality” increases the demand for Treasuries during uncertain times. This increased demand can increase the price of Treasuries, which lowers their respective market yields. If an expert mechanically incorporates these lower Treasury market yields into a cost-of-equity-capital analysis in the current environment, the result can be a lower discount rate. This lower discount rate can imply that a company is less risky (and more valuable) than it was prior to the current environment.

When conducting valuations, experts should consider whether the current Treasury yield is the proper rate to use in the calculation of the cost of equity capital. It might be more appropriate to use a “normalized” or expected long-term Treasury yield if the valuation date occurs after mid-February 2020.

Yields on corporate debt are also changing due to the flight to quality. Accordingly, debt balances and interest rates reported on the financial statements of public companies may require further analysis. In addition, care should be exercised when estimating the components of debt and equity capital used in the calculation of the discount rate. Failure to do so could result in both an unreliable discount rate and indication of value.

In addition to the income approach, the market approach is a widely used business-valuation approach. The market approach is also susceptible to distortions attributable to the current environment.

Market Approach

The market approach is based on transactions involving the equity securities or business enterprises of publicly traded or privately held companies. When conducting the market approach, the expert will use market transactions to develop earnings multiples, which are then used to value the subject company.

Typically, the valuation methods used in the market approach are twofold: (1) merger-and-acquisition (M&A) method and (2) guideline-public-company (GPC) method. The current environment has had a substantial impact on the application of both of these methods for valuation dates occurring after mid-February 2020. Accordingly, modifications to the traditional application of these methods might be appropriate in order to conclude reliable indications of value.

M&A Method

M&A multiples are calculated by dividing the purchase price of the target company by its earnings. Prices paid in M&A transactions negotiated prior to mid-February 2020 likely do not reflect the impact of the current environment. In addition, the economic uncertainty, risk-aversion and tightening of corporate debt markets have reduced the flow of M&A transaction activity that would ordinarily serve as relevant data points for contemporaneous valuations.

If an expert is able to identify relevant M&A transactions, caution should be exercised when applying M&A multiples to the earnings of a subject company. Whether the earnings and purchase price of the target company are

impacted by the current environment will be an important consideration in the analysis. Inconsistent measurements of the purchase price, earnings of the target company and earnings of the subject company may result in unreliable indications of value.

GPC Method

COVID-19 has had a substantial impact on public capital markets during 2020. From Feb. 19 to March 23, the major stock market indices experienced one of the most significant declines since the 1929 Great Depression. However, since March 23, these same capital markets have fully recovered and fueled speculation about a V-shape recovery.

GPC multiples are calculated by dividing the equity or enterprise values of public companies by their respective earnings. If these multiples are calculated based on stock prices occurring after mid-February 2020 and earnings that do not reflect the current environment (*e.g.*, financial statements dated Dec. 31, 2019), the application of these multiples to the earnings of a subject company, which are affected by the current environment, might be problematic. Given these potential issues, it is appropriate to consider what modifications to the M&A and GPC methods are appropriate in order to properly address the disruptions associated with the current environment.

Modifications to the Market Approach

It appears that the conditions associated with the current environment were not fully reflected in the capital markets until mid-February 2020. Accordingly, in situations where the valuation date occurs before mid-February 2020, no modifications to the traditional application of the market approach may be necessary. However, when the valuation date occurs after mid-February 2020, experts may wish to consider the following alternative valuation methods.

Alternative M&A Method 1

If the purchase price and earnings of the target company reflect the current environment, it might be appropriate to calculate and apply these multiple(s) to the affected earnings of the subject company. This can occur when the M&A transaction occurs after mid-February 2020 and the reported earnings of the target company also reflect the impact of the current environment.

If the purchase price of the target company reflects the current environment (the “affected purchase price”) but its earnings do not (the “unaffected earnings”), the multiples derived from the transaction may not be appropriate to the earnings of a subject company affected by the current environment (the “affected earnings”). This can occur when the M&A transaction occurs after mid-February 2020, but the reported earnings of the target company are from an earlier, unaffected period (such as 2019). If this multiple is applied to the affected earnings of the subject company, the impact of the current environment might be double-counted, resulting in an unreliable indication of value. In order to correct this analysis, the following procedures may be appropriate: (1) Divide the affected purchase price of the target company by its unaffected earnings (this calculation will provide the “affected M&A multiples”); (2) the affected earnings of

the subject company should then be adjusted to remove the impact of the current environment, resulting in its unaffected earnings; and (3) apply the affected M&A multiples to the unaffected earnings of the subject company to estimate the value of the subject company affected by the current environment (the “affected value”).

Alternative M&A Method 2

If the current environment has not affected the purchase price of the target company (the “unaffected purchase price”) and the unaffected earnings of the target company are used in the calculation of the multiples, the following procedures may be appropriate: (1) divide the unaffected purchase price by the unaffected earnings of the target company to calculate the “unaffected M&A multiples”; (2) if the earnings of the subject company are the affected earnings, adjust these earnings to quantify its unaffected earnings; (3) apply the unaffected M&A multiples to the unaffected earnings of the subject company to estimate the value of the subject company unaffected by the current environment (the “unaffected value”); and (4) conduct an income-approach analysis to estimate the value detriment attributable to the current environment for the subject company, which should provide an estimate of damages attributable to the current environment for a discrete time period, then subtract this damage estimate from the unaffected value of the subject company to estimate its affected value.

Alternative GPC Method 1

If the stock price and reported earnings of the public companies reflect the impact of the current environment (*i.e.*, after mid-February 2020), no modifications to the traditional application of the GPC method might be necessary. However, if the valuation date stock price reflects the impact of the current environment (the “affected stock price”), but the reported earnings used in the calculation of the GPC multiples are the unaffected earnings (*e.g.*, derived from Dec. 31, 2019, financial statements), the multiples derived from this analysis might not be appropriate for application to the affected earnings of the subject company.

This is due to the fact that the multiples are calculated by dividing the affected stock price by the unaffected earnings of the GPC. If this multiple is then applied to the affected earnings of the subject company, the impact of the current environment might be double-counted, resulting in an unreliable indication of value. In order to correct this analysis, the following procedures may be appropriate: (1) divide the affected stock price by the unaffected earnings of the GPC to calculate the “affected GPC multiples”; (2) if the earnings of the subject company are the affected earnings, adjust these earnings to quantify its unaffected earnings; or (3) apply the affected GPC multiples to the unaffected earnings of the subject company to estimate the affected value of the subject company.

Alternative GPC Method 2

An alternative to GPC Method 1 is conducted using the following procedures: (1) divide the GPC stock price unaffected by the current environment (the “unaffected stock price”) by the unaffected earnings of the GPC to calculate

the “unaffected GPC multiples”; (2) in order to quantify the unaffected GPC multiples, it is necessary to identify a date for the unaffected stock price to use in the analysis (this date will likely be different than the valuation date because the stock price as of the valuation date presumably reflects the impact of the current environment; potential dates may include (a) the unaffected stock price date closest to the valuation date, (b) the date of the financial statements of the GPCs used in the calculation of multiples (under the assumption that the financial information is known or knowable); or (c) the first trading day after the financial statements are publicly disclosed by the SEC); (3) if the earnings of the subject company are the affected earnings, adjust these earnings to quantify its unaffected earnings; (4) apply the unaffected GPC multiples to the unaffected earnings of the subject company to estimate the unaffected value of the subject company; and (5) conduct an income approach to estimate the value detriment attributable to the current environment for the subject company, which should provide an estimate of damages attributable to the current environment for a discrete time period, then subtract this damage estimate from the unaffected value of the subject company to estimate its affected value.

Conclusion

The current environment is reshaping the valuation landscape. Accordingly, the mechanical application of traditional valuation methods may produce values that lack credibility and reliability. It is important for valuation experts and bankruptcy lawyers to consider whether modifications to traditional valuation methods are appropriate for any given engagement. If modifications are conducted, the expert should be prepared to provide supportable reasoning for those changes. **abi**

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