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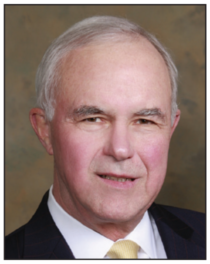
Suggested Reading

Reviewed by John M. Bonora

A Practical Guide to Bankruptcy Valuation

Written by:
Dr. Israel Shaked and Robert F. Reilly
(ABI, 2013)



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A Practical Guide to Bankruptcy Valuation is intended to provide practical guidance to valuation analysts, financial advisers, restructuring attorneys and other professionals involved in the valuation of bankrupt or otherwise financially distressed businesses. The book succeeds in its mission and represents a valuable new resource to these multiple constituencies. The book's authors, **Dr. Israel Shaked** (The Michel-Shaked Group; Boston) and **Robert F. Reilly** (Willamette Management Associates Inc.; Chicago), serve as the coordinating editors for the *ABI Journal*'s Value & Cents column and have a wealth of knowledge and practical experience in this subject area. Some of the chapter sections of *A Practical Guide to Bankruptcy Valuation* were originally published in the column.

Book Overview

The book begins with a review of the principles of valuing business enterprises, fractional business interests and securities, and includes specific discussion of the areas in which the valuation analysis needs to give special consideration to the subject entity's distressed situation. These areas include difficulties in applying the income approach, selection of the appropriate premise of value, difficulties in applying earnings-based market multiples, and assessing the reasonableness of the debtor's financial projections.

Chapter 3 focuses on the role of the financial adviser and valuation analyst in assessing the causes of a company's distress, determining solvency, and actions taken while in the zone of insolvency. The authors identify seven common causal factors in driving businesses to the zone of insolvency.

High Operating Risk Combined with High Financial Risk

Many debtor companies operate in an environment characterized by high risks related to changing technology, powerful new entrants, a skewed customer base, easily substitutable products, competitive distribution channels, high vulnerability to the economic cycle and other factors. If the debtor also has a significant amount of debt, a downturn in a business already straddled with high debt service costs can cause its doom.

The Winner's Curse

In any given transaction, there is a reasonable chance that the acquirer will overpay. A company built through acquisitions may have overpaid for a significant amount of its operating units. Translation: Baring significant synergies and superb management, the parent company will not be able to earn a satisfactory return on the funds used to make the acquisitions.

Blind Faith in Investment Bankers

Investment bankers play a large role in the corporate acquisition process, and acquisitions are a source of significant income to them. However, there is a large body of evidence that serial acquirers earn low returns. Are investment bankers really looking out for the well-being of their clients? In many cases, the driving force behind a bad deal may have also been the investment banker's bottom line. The acquisition process frequently causes financial distress to the integrated company.

Imprudent Debt Levels Driven by Commercial Banks

Valuation analysts are frequently surprised when a major lender provides significant funding in a transaction headed for bankruptcy or financial distress. The authors assert that in the event of financial distress, as secured lenders the banks frequently come out whole, while the effect on the borrower of taking on too much debt may have been disastrous.

Reacting to, Rather than Anticipating, Technological or Competitive Change

The odds are stacked against an industry leader continually making the right bets on technology, distribution channels, executive talent and manufacturing strategy, year after year. Unfortunately for many technology-based companies, being upstaged by changing technology often results in declining sales, cash flow and potential financial distress.

Rapid Structural Change

Innovation such as the computer replacing the typewriter, email's impact on postal mail and telephone usage, and big box stores and the Internet's impact on local retailers are examples of structural changes that have caused some companies to adapt (*e.g.*, IBM) while others deteriorated into distress (*e.g.*, the U.S. Postal Service, Ames, Woolworth's, etc.).

Cooking the Books

The reputational damage caused by cooking the books makes it particularly difficult to regain credibility with customers and vendors (as in the cases of WorldCom, Adelphia and Tyco).

Three Groups

The authors also state that it may be possible to classify most companies in financial distress into three main groups. They then contrast the issues facing each group and suggest preferred strategic alternatives:

1. *Solvent but lacking adequate capital (sometimes referred to as a "good business" with a "bad balance sheet"):* These companies have potentially valuable assets but run the risk of being unable to achieve that value due to a near-term shortage of funds. Their ultimate success requires breathing room in terms of relaxed credit terms and/or a recapitalization so that the value of its assets may be realized in the form of future cash flows.
2. *Insolvent but have enough capital to satisfy their obligations as they become due, at least in the near-term (sometimes referred to as a "bad business" with a "currently satisfactory balance sheet"):* These companies possess adequate capital in the near term but will exhaust these capital reserves in the long-term. The value of these businesses is declining, and to maximize stakeholder value, immediate steps need to be taken to wind down cash-losing business lines, sell noncore operations and increase support for business lines that still show the potential to provide value to stakeholders.
3. *Both insolvent and lacking adequate capital (sometimes referred to as a "bad business" with a "bad balance sheet"):* These companies frequently file for bankruptcy in the absence of outside intervention. Depending on the company and the industry, it may be possible to develop and execute a strategy to recover value. Such strategies may require the assistance of workout and bankruptcy professionals.

Bankruptcy Valuation Analyst Guidelines

The concluding chapter of *A Practical Guide to Bankruptcy Valuation* is an excellent summary of the book's contents in the form of a listing and description of the bankruptcy valuation analyst guidelines.

There Is an Extensive Scope of Services that Valuation Analysts Can Provide within the Bankruptcy Discipline

As business bankruptcies have become more complex and contentious, the need for valuation services has expanded. These services include the valuation of debtor businesses, business ownership interests, securities and intangible assets. These services can take the form of solvency opinions, valuation of creditors' collateral, transaction-fairness opinions and other financial-advisory opinions. Valuation analysts also perform forensic accounting investigations and may help identify cash-generating business or asset-sale opportunities. Valuation analysts may also help develop a reorganization plan, assess the reasonableness of a reorganization plan and quantify the income tax and financial accounting implications of a reorganization plan.

An Analyst Should Understand and Document All Elements of the Bankruptcy Valuation Assignment

An analyst's engagement letter and subsequent report should clearly document the key elements of the valuation assignment. In bankruptcy-related valuations, it is especially important for counsel and the analyst to have a clear agreement on the basis upon which the valuation will be prepared. These elements include the valuation subject (what debtor businesses, assets or securities are the subject of the analysis), the subject ownership interest (typically, but not always, fee-simple), the standard of value (typically, but not always, fair market value), the appropriate premise of value (typically, but not always, value in continuing use as a going-concern) and the appropriate valuation date.

An Analyst Should Perform Appropriate Due Diligence in the Bankruptcy Valuation Assignment

Valuation analysts typically perform reasonable data-gathering and due diligence as a prelude to their quantitative and qualitative analyses. Documents to be obtained should include historical financial, operational and legal documents (including the bankruptcy proceeding) regarding the subject business or assets, as well as publicly available information regarding the debtor's industry, guideline public companies and guideline sale transactions. In addition, the analyst performs due diligence related to any debtor company prospective financial information, which should include an assessment of the debtor's historical ability to project financial results, its current competitive position and operational constraints.

Generally Accepted Valuation Approaches, Methods and Procedures

Valuation analysts are aware of the generally accepted valuation approaches and can describe them to counsel, finders of fact and others. Analysts do not simply use these approaches just because they are documented in promulgated standards and professional literature. Generally accepted methods are relied on because they are based on fundamental economic principles and established valuation theory.

Accepted Vocabulary Used in the Valuation Profession

Most professions use technical jargon specific to that profession that is meant not to obfuscate issues, but to clarify them. The *Guide* employs the terminology that has been adapted by the four professional business valuation organizations in the U.S., as embodied in *The International Glossary of Business Valuation Terms*.

Generally Accepted Valuation Professional Standards and Practices

Each of the four U.S. professional business valuation organizations has training and testing programs that lead to business valuation credentials, and each has a code of ethics and a set of professional standards to which their credentialed valuation analysts subscribe. While there is no statutory, regulatory or judicial requirement that a bankruptcy valuation analyst be credentialed by any professional organization, the lack of relevant credentials may preclude a prospective expert's testimony from being heard by the court.

Income Tax and Financial Accounting Implications to Most Bankruptcy-Related Valuations

A Practical Guide to Bankruptcy Valuation provides a good discussion of the taxation and accounting implications related to bankruptcy filings, bankruptcy transactions and bankruptcy emergences. These can be very complex and include the recognition of cancellation-of-debt income and recent changes in financial statement disclosure requirements related to "troubled debt restructuring."

Valuation Analysts Should Be Familiar with Intangible-Asset Considerations of Bankruptcy Valuation

The book's authors remind the reader that intangible-asset valuation analyses may be a component of a debtor company's solvency analysis, fair market value analysis, transaction-fairness analysis, reasonably equivalent value analysis and other bankruptcy-related analyses. They discuss the categories into which intangible assets are commonly grouped and the approaches best suited to valuing a troubled company's various types of intangible assets.

Valuation Analysts Should Be Familiar with Real Estate and Tangible Personal Property Considerations

A Practical Guide to Bankruptcy Valuation notes that while many valuation analysts are not experienced real estate or tangible personal property appraisers, the value of a debtor company's tangible assets could impact a solvency analysis, fair market value valuation, collateral value analysis, transaction-fairness opinion or reasonably equivalent value opinion. The valuation analyst should be familiar enough with tangible asset-appraisal principles and procedures to be able to explain the appraisal analyses and conclusions to the client, the client's counsel and the bankruptcy proceedings triers of fact.

Valuation Analysts Should Be Familiar with Generally Accepted Valuation Reporting Standards

The book's authors note that valuation disputes are common in bankruptcy proceedings and that accordingly, valuation expert reports and expert testimony are also common. The authors discuss at some length the Federal Rules of Evidence and relevant case law (*i.e.*, *Daubert*, *Kumho* and *United Phosphorus*) related to the admissibility of expert testimony. It notes that courts seem to give a great deal of weight to the opinions of experts who have valued similar assets in the past. This section of *A Practical Guide to Bankruptcy Valuation* then focuses on the practical aspects of bankruptcy valuation engagements, including the preparation of complete, cogent reports in compliance with the business valuation standards. The authors provide guidance to counsel in their selection of a valuation expert and encourage early engagement of an expert who, in addition to being technically skilled, is most importantly a good communicator, as ultimately the expert's job is to make the complex understandable to a judge or jury.

Conclusion

On one level, readers will come away with a greater understanding of the vital and complex role that valuation plays in the realm of bankruptcy. Most importantly, *A Practical Guide to Bankruptcy Valuation* is an excellent "how-to" ready reference manual for practitioners. abi

Editor's Note: *To purchase your copy of* A Practical Guide to Bankruptcy Valuation*, visit the ABI Bookstore at bookstore.abi.org (ABI members must log in first to obtain special pricing).*

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