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Valuations – the new old battleground in restructuring

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Introduction

The recently enacted Corporate Insolvency and Governance Act 2020 (CIGA 2020) represents the biggest change to the UK restructuring regime in a generation.

One of its most notable features is the introduction of a restructuring plan (RP), which may mean one or more classes of dissenting creditors being crammed down. A court will approve the RP if at least one class of creditors with a genuine economic interest in the outcome of the RP votes in favour (at least 75% of votes by value), and it can be demonstrated that the proposed RP leaves other classes no worse off than under the 'relevant alternative'. The 'relevant alternative' being whatever the court considers would be most likely to occur if the plan were not to be sanctioned.

The question of whether particular classes of creditor in a company are better or worse off essentially boils down to opinions over where value breaks in a capital structure under different scenarios (as illustrated below).

Under each 'relevant alternative', the valuation flows through a waterfall of creditor classes, via an often complex entity priority model (EPM), which is critical to determining the financial outcome for each creditor group. Through this process, valuation becomes one of the major battlegrounds between stakeholders, and as experience from Chapter 11 has shown, these battles can be long and nasty.

Over the last month we have made a number of soundings in the market as to how traditional valuations will interact with CIGA 2020. In this article, and further informed by those soundings, we share our thoughts on establishing robust valuation positions and the challenges of doing so in the uncertain and volatile environment caused by the pandemic. In particular we explore the tried and tested approach of liquidation value, but contrast that with other 'relevant alternatives', such as distressed going concern value.

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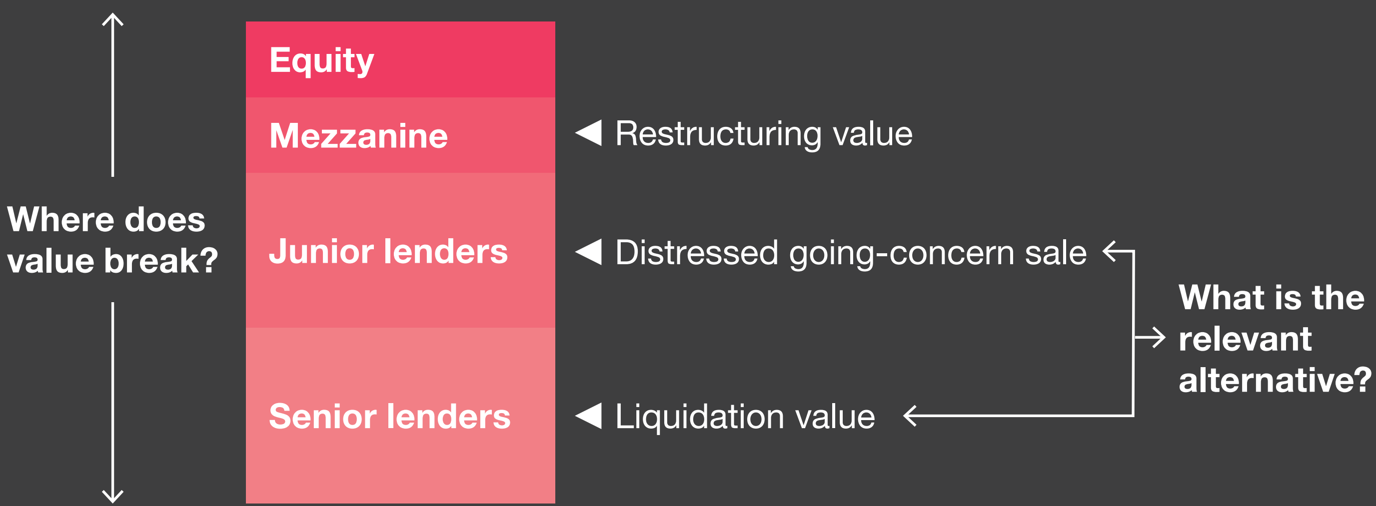

Drawing upon practical experience when assessing liquidation value

Under the RP, a creditor or shareholder class must be left no worse off than they would have been in the case of the 'relevant alternative'. In the majority of cases the 'relevant alternative' is likely to involve a distressed going concern sale process (see below), but in some cases it will mean liquidation, especially if the company would rapidly run out of funds absent a restructuring. The liquidation value comprises the proceeds that would be realised in an orderly (but distressed) sale of the business and/or assets of the company. The price achieved is usually lower than the market value, but how much lower?

While distressed valuation benchmarks are available for some asset classes, for many there are limited data points (especially for intangible assets, such as brands or patents), so assessing appropriate discounts requires judgment and the practical experience of selling similar assets in accelerated processes.

We are finding that in the post-COVID-19 environment, illiquidity is becoming more of a factor and discounts to asset values may be expected to be higher as a result of a shrunken marketplace. Paradoxically, at a time when creditor interests are under pressure, so too are the underlying business or asset values – liquidation value may therefore be lower than in the pre-crisis environment. If a company's liquidation value is low in the crisis environment, even a marginally better outcome for creditors may be enough for them to support the RP.

As a result, we expect liquidation values will need to be supported with more objective evidence of asset discounts, backed by commercial judgement and experience, rather than rough rules of thumb.

The 'relevant alternative' may well not be liquidation

Dissenting creditors are required to be left no worse off[1] than under the 'relevant alternative'. But how many relevant alternatives does the valuer need to consider among a potential myriad of options? In practice the relevant alternative may be dictated by the length of the cash 'runway' a company has left; if, absent a restructuring, the company will run out of cash within weeks, then liquidation may be the default[2].

Liquidation is typically a worst-case outcome for creditors, so there is a strong incentive for dissenting classes to argue higher value yielding alternatives. For some large strategic businesses this could even involve some form of nationalisation, but in most situations the 'relevant alternative' is more likely to involve a going concern sale of the business or elements of the business.

If the 'relevant alternative' is a going concern sale, market testing may provide the best evidence of value and, if feasible (i.e. there is a sufficient cash runway to give the company time to engage in a market testing process and it would not be a value destructive exercise), should be pursued.

In some instances, however, we expect such processes to be challenged due to the inactive market, short timescales for a restructuring due to cash flow constraints, and/or unwillingness to publicly announce a sale when a business is in distress.

Regardless of whether market testing is a feasible route, an independent valuation is likely to be needed (either as a primary way of assessing value or to complement market testing). This would typically assume the business is marketed for sale in its current state. More conventional discounted cash flow (DCF) and market multiples-based valuation approaches would provide a proxy for what a buyer might pay for the business under these circumstances, albeit with the potential overlay of a discount for distress. Such a valuation will need to be supported by strong industry analysis, grounded in commercial reality, based on an objective viewpoint at all times. Consideration also needs to be given to the timing of the valuation assessment. If the restructuring process drags on for months, certain alternatives might no longer be viable and/or the valuation may have changed materially, especially in the current volatile environment.

[1] We interpret 'worse off' being from a purely financial standpoint.

[2] Virgin was recently restructured using the provisions of CIGA 2020, but in this case liquidation was shown to be the only relevant alternative to the proposed RP.

A DCF valuation is only as robust as the business plan supporting it

The RP value represents the value of the entity immediately after the RP is approved, and incorporates the opportunities afforded by the injection of new capital or relaxation of funding constraints. It will often be assessed using a DCF method, based on the net present value of future cash flows that the emerging entity is expected to generate as a going concern. The plan (or plans, should there be more than one restructuring scenario envisaged by the company) needs to be feasible so as not to risk liquidation down the line, or the need for further financial restructuring.

We can already see how uncertainty about the future caused by COVID-19 has played a significant role in valuation issues in Chapter 11 in the US. As a result, proposed plans have faced increased scrutiny from creditors regarding whether such plans are in fact ‘feasible’ in the current market climate.

If the ability of a company to survive after restructuring is in serious doubt, the RP may be called into question, allowing creditors to push a company towards liquidation.

The valuer’s ability to assess a plan, especially in the current environment, will require management time and input from industry specialists. The valuer may need to consider multiple scenarios and sensitivity analyses reflecting a wider range of potential outcomes.

What happens after the plan?

Given the material impact of terminal value calculations[3] in almost every DCF valuation, an extension of the projection horizon may also be necessary to derive an appropriate post-restructuring and post-COVID-19 ‘steady-state’ position to which to apply a terminal growth rate or multiple. In a world where people are predicting fundamental changes to the way we live and work, when will that steady state be reached and how will margins and capital requirements compare to the pre-COVID-19 position?

The terminal value itself will need to take account of both macroeconomic and company specific factors. Considerations covering economic growth, inflation, sector outlook, the company’s position in its lifecycle and fundamental expectations about demand for its products or services longer term will all be relevant to any choice of terminal multiple or long run growth rate. Defaulting to a long term inflationary growth rate without further consideration is likely to be too simplistic.

[3] The terminal value represents the future value of the business after the discrete projection period.

Discount rates are not the place to capture increased uncertainty

Aside from the cash flow forecasts, the other major assumption within DCF valuations is the discount rate (i.e. the weighted rate of return required by debt and equity providers, typically calculated using a CAPM model). Whilst a technical concept, ultimately the discount rate is seeking to identify the level of return a market participant would require for owning and financing the asset in question. Interestingly, the recent 'flight to quality' has seen many safe-haven bond yields and therefore discount rates decline, but the cash flows of companies in a distressed going concern scenario are likely to exhibit more volatility or uncertainty and so a reduction in discount rates would be unexpected.

A simplistic way of adjusting valuations to take account of today's increased risk and uncertainty (where these are otherwise not captured in the cash flows) may be to add a so-called 'alpha premium', increasing the discount rate and decreasing the valuation. However, the inclusion of unsupported premiums in discount rates is likely to be challenged by courts and dissenting creditor groups, placing the emphasis back on robustly thought-through cash flow scenarios and justifiable probabilities assigned to each of those scenarios.

Given market volatility, are market multiples still a reliable benchmark?

Trading company multiples generally provide a strong alternative valuation method to DCF, but can they still provide reliable benchmarks when the level of volatility in global equity markets has surpassed levels experienced at the start of the financial crisis?

We think they can. Share prices still provide relevant views on how the market is interpreting the future post-COVID-19, which, with transaction levels significantly down, will still be an important alternative valuation method to DCF.

One of the most frequently asked questions of us is whether valuations in 12 months (post-COVID-19) are likely to be higher than values today and/or revert back to pre-COVID-19 levels. The answer differs from sector to sector and can be seen in the embodiment of differing expectations about the future in current, quoted company share prices.

While the COVID-19 uncertainty is weighing on the market and causing volatility in share prices, we are not expecting a post-COVID-19 universal rebound to where valuations were in early 2020 (and indeed share prices today should capture future expectations of a rebound).

Take airlines as an example. On the announcement of promising vaccines, airline share prices jumped 20% in a day, but they are still approximately 30% down on pre-COVID-19 levels. Video chat businesses like Zoom showed the opposite effect. Other sectors have experienced a fundamental change in the nature of their operating models or outlook (e.g. retail, office real estate) such that their values are likely to have shifted indefinitely, with winners and losers along the way.

For these reasons, values, share prices and multiples will have to be interpreted with care. A pertinent question for valuers to ask will be whether the earnings of comparable companies have been appropriately adjusted as a result of issues with the supply chain and/or changes in the demand for products/services. For example, historical multiples may be depressed by being based largely on higher pre-COVID-19 earnings. Applying them to an entity's COVID-19 adjusted earnings could undervalue the business.

The role of the valuer – independent expert rather than advocate

The formal role of the valuer will largely depend on how contentious the process is (or is expected to become). If there is general alignment between the different stakeholders and/or it is the case that certain classes are very obviously out of the money under the relevant alternative, a formal valuation process might not be necessary and the company's financial adviser could provide sufficient valuation input. If, however, it is expected that the valuation will be a key area of contention, it could be advisable for the company (and potentially each creditor class) to appoint their own truly independent valuer – i.e. a valuer who has not had any existing role in the process to date.

An independent valuer may be appointed by the company or by a particular class of creditors, but his or her report will be adopted as a piece of valuation evidence by the courts, who will look for an objective valuation on which they can base key judgements, such as which stakeholders are in or out of the money.

The valuer may need to represent and defend his/her valuation in court against a valuer appointed by dissenting creditors. This will not be the time to take shortcuts or be seen to adopt an advocacy position. Valuation experts will need to be fully versed in the relevant industry issues and court/expert witness experience may also come to the fore, in order to understand how to present valuation issues to the judiciary, the duties of the valuer and appropriate conduct and approach to engaging with other stakeholders.

A reminder of the lessons from IMO

With valuation battles likely to play out in court, the relevance of some of the key valuation judgments made in the IMO Carwash case[4] will be particularly pertinent in light of this new legislation. In that case, PwC provided valuation analysis on behalf of the senior lenders, and so has first-hand experience of the valuation-court-contentious restructuring scenario. Relevant insights gleaned were:

Real world judgments and experience are key. IMO emphasised the importance of applying commercial, real world experience over theoretical valuation approaches involving limited professional judgement.

Concluded valuation ranges need to be narrowed by professional judgment. The current level of market uncertainty is causing valuers to broaden their concluded ranges, but IMO highlighted the preference for narrower ranges supported by professional judgement, even if arguments are subjective. The Court will be disappointed by an expert unwilling to give an opinion.

Market insights add credibility to the assessment of the company's strategic options. The options open to companies in a post-COVID-19 world will be very different. In IMO, strong industry knowledge helped the valuer demonstrate that they had given adequate consideration to the relevant alternatives.

Assessing current market value requires a strong understanding of the buyer universe. Valuers need to understand the motivations and strategies of trade and financial buyers, which may be very different post-COVID-19. This again will support a robust assessment of the relevant alternatives.

[4] The IMO Carwash case received significant publicity in August 2009, when the UK High Court reached the conclusion that the valuation analysis prepared by PwC on behalf of the senior lenders demonstrated that the mezzanine lenders did not have an economic interest in IMO and therefore they were not entitled to contest a proposed Scheme of Arrangement.

Insights from market soundings

Over the last month we have made a number of soundings in the market to discuss valuation in the context of CIGA 2020. There was a high degree of consensus, with the top five takeaways being:

1. Valuation is expected to be a major battleground under CIGA 2020.
2. A robust, commercial, industry specific assessment of the relevant alternative will be the key input to any valuation.
3. Entity priority modelling (EPM) to show returns to creditors is increasingly complex and fundamental to the process.
4. The role played by the valuer (independent expert vs. a core part of the financial advisory team) will be driven by how contentious the process is expected to be.
5. Whilst valuers should be engaged early in the process, valuations will need to be refreshed to remain current in a rapidly changing environment.

Conclusion

Valuation has always been a subjective exercise. The economic effects of the pandemic have further complicated valuation issues as companies struggle to reorganise in these economically challenging times. As with many aspects of the crisis, thoughtful debtors and creditors may attempt to use the unique economic circumstances to protect and further their interests using the provisions of CIGA 2020. Valuation, followed by entity priority modelling of that valuation through to each creditor class, will be central to these cases. A strong understanding of the valuation issues and an objective value, supported by commercial judgement and sector insights, will be a core expectation of all valuers by courts, companies and creditors combined.

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