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Valuation Report

Business Valuation Trends and Strategies

Winter 2015

Litigation Update

Genco Case Illuminates Key Valuation Issues

2014 was a year of interesting bankruptcy cases. One decision that's particularly noteworthy is *in re Genco Shipping & Trading Ltd.*, in which the court ruled that net asset value (NAV) — a method not often used in the valuation of business operations — was appropriate to value the company.

The case also highlighted the importance of expert credibility, a must in litigation. Here's a look at what transpired.

The Reorganization Plan

Genco Shipping & Trading is an international shipping company that transports "dry bulk" products worldwide via a fleet of 53 vessels. In April 2014, Genco filed for Chapter 11 bankruptcy and submitted a voluntary pre-packaged reorganization plan.

The plan hinged on a debt conversion restructuring that the majority of its lenders supported. Under the agreement, approximately $1.2 billion of the more than $1.3 billion in senior secured debt would convert to equity in the reorganized company and there would be new liquidity through a "fully backstopped $100 million rights offering." In exchange for giving up their equity interests, the existing equity holders would receive warrants covering 6 percent of the new equity.

The equity holders were unsatisfied with this deal and rejected the plan. The debtors then turned to the bankruptcy code's "cramdown" provision, asserting that their plan was "fair and equitable" and should be adopted.

A trial ensued to determine whether the plan should stand. The question centered on whether the company's total enterprise value (TEV) exceeded $1.48 billion, which was the amount the debtors deemed necessary to pay claims ahead of the equity holders. If the TEV exceeded that number, the equity holders would be entitled to recovery.

Proposed Valuation Methods

Each side's experts used four methods for the valuation: NAV, comparable companies, precedent transactions and discounted cash flow (DCF).

The debtor's experts favored an NAV analysis, which they believed was best suited to the shipping industry. NAV is defined as the value of an entity's assets minus the value of its liabilities. While it's not unheard of to use NAV in a business valuation, it is not common.

But in this case, the debtors argued that NAV was appropriate because the industry was "fragmented, competitive and had low barriers to entry," and a market valuation of the assets was the treatment required. Their expert's NAV analysis resulted in a value between $1.36 billion and $1.44 billion, which was under the magic number of $1.48 billion.

The equity committee expert suggested weighting the four methods, giving DCF and comparable companies 74

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Exit Planning

Put Yourself in the Mind of a Buyer

Whether you're ready for retirement or just anxious to move on to the next thing, selling your business in the most lucrative way requires planning. Few businesses are always "valuation ready," but getting (and keeping) your company in top shape at all times is a worthy goal.

Put yourself in the mind of a potential buyer and consider how your company stacks up relative to these key value drivers:

- **Earnings:** Consistent earnings measured by EBITDA are the top priority for buyers. Are there operational efficiencies you can implement to legitimately boost margins and increase cash flow? Is your pricing optimized? Are your expenses pared? Are you making the most of proprietary technologies or patents?

Value is driven by future potential — not what happened in the past.

- **Growth:** Buyers are looking for a rosy future. If your business is not positioned for growth, your prospects for sale are grim. That's why it is imperative to stay ahead of the curve in terms of anticipating the needs of the market, honing your product or service mix, and presenting your offering in the most compelling way. To be attractive, your company must be growing — or have clear potential for growth.

- **Transferability:** One of the risks of entrepreneurship is making yourself indispensable to the health of your company. If you have all of the vision, all of the operational know-how and all of the customer connections, the company is worthless without you as its owner. A buyer will be looking for a strong, seasoned management team to run the company after you're gone.

- **Manageable risk:** Diversity is the key here. You don't want to rely too heavily on just a few suppliers or customers because, if a key vendor or client goes away, your company might suffer irreparable harm. The same is true of relying too heavily on one product line: If a vibrant new competitor pops up, your company will lose its relevancy. Diversify your supply chain and income stream to ensure long-term health.

- **Good housekeeping:** As boring as it may seem, good housekeeping is vitally important to the sale of a company. This includes quotidian tasks such as cleaning up the books and removing personal expenses, as well as optimized tax positioning and planning, and up-to-date financial projections and business and strategic plans. A scrubbed and shiny, ready-for-sale company is likely to be much more attractive to buyers than one that seems disheveled and poorly organized.

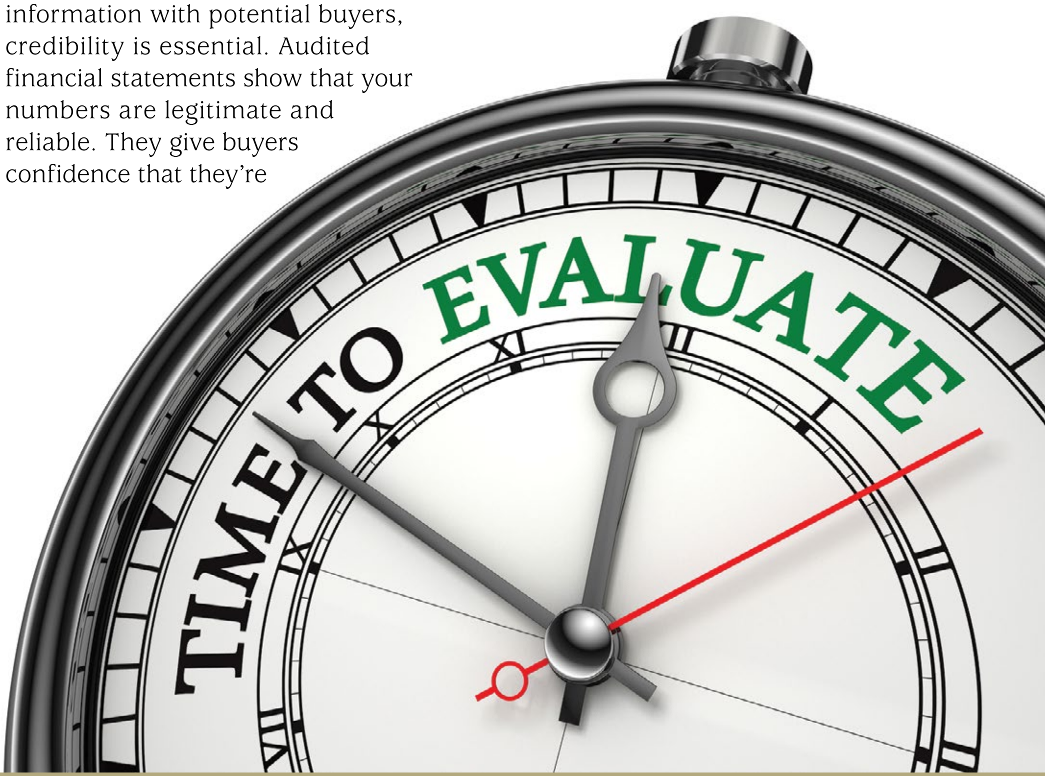
- **Audited financial statements:** When it comes to sharing financial information with potential buyers, credibility is essential. Audited financial statements show that your numbers are legitimate and reliable. They give buyers confidence that they're making decisions based on the company's true performance, not inflated or deflated numbers.

A scrubbed and shiny, ready-for-sale company is likely to be much more attractive to buyers than one that seems disheveled and poorly organized.

Remember, value is driven by future potential — not what happened in the past. Make sure the best years for your company are ahead, not behind.

Also recognize that getting your company ready for sale takes time, so start early. Planning three to five years out is a reasonable window for most companies. ■

We can help you get your company prepped for sale. Contact us today to set up a time to talk about how to reap maximum value from your business.



Genco Case Update

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percent weight, NAV 15 percent weight and precedent transactions 10 percent weight. This calculation resulted in a range of $1.54 billion to $1.91 billion, which would provide value to the equity holders.

The court ruled as follows:

- **NAV:** The debtors hired four firms to conduct appraisals of Genco's fleet, which resulted in a value of $1.21 billion. Adding in the company's other assets resulted in a NAV of up to $1.44 billion.

The equity committee didn't argue the numbers, but rather contended that using NAV wasn't appropriate when valuing an ongoing business.

The court rejected the equity committee's argument, and agreed with the debtors that NAV was in line with the nature of the industry.

- **Comparable companies:** While both sides used similar methodology and data, the experts disagreed about which companies were actually "comparable," and also about the EBITDA adjustment for fleet age. The debtors' experts identified six comparable companies and performed two comparisons: a TEV/NAV analysis and a TEV/EBITDA analysis. The TEV/NAV analysis produced values ranging from $1.2 billion to $1.32 billion, and the TEV/EBITDA analysis resulted in $1.17 billion to $1.41 billion. Either way, the equity holders were out.

Not surprisingly, the equity committee's expert had a different opinion. He excluded two companies from the peer group of comparable companies due to various issues with their size, governance and TEV.

The court agreed to exclude the first comparable but not the second, and performed a "common sense check" which resulted in a value range in line with the debtors' experts.

- **Precedent transactions:** Both sides agreed that there were few "change-in-control" transactions that mirrored the Genco situation. The debtors' expert proposed six comparable transactions, including five that were fleet acquisitions versus "change-in-control" transactions and thus were deemed to be not particularly relevant. This calculation resulted in a value between $1.29 billion and $1.4 billion.

The equity committee's expert disputed that approach, instead suggesting that a proper precedent transaction method should consider what buyers would pay for a full business, not just the fleet.

The court found only three "change-in-control" transactions of interest, all of which took place at or close to NAV.

- **DCF:** The equity committee relied heavily on its DCF valuation, which resulted in a favorable midpoint value of $1.96 billion. The debtors' expert rejected DCF as a reasonable methodology for Genco because of the difficulty of making accurate projections.

The court agreed with the debtors, and also found that the equity committee's expert used flawed data in his shipping forecasts. Rather than relying on an established industry risk evaluation system, the equity committee expert relied on another expert who had no specific rate forecasting experience. Among other flaws in his numbers, the court was particularly underwhelmed by the equity committee expert's simplistic way of handling the data without any adjustments.

Questionable Appraiser

Perhaps the most damaging finding from the court was that the equity committee's expert had presented prior statements that undermined his arguments at trial. For example, the expert had produced materials that essentially supported the debtors' contention that DCF was not an appropriate methodology.

In addition, the equity committee's expert had initially approached the debtors hoping to be their advisor. In his discussions with them, he had allowed for a shortfall in collateral value based on his preliminary analysis. When his firm wasn't hired, the expert changed his mind. The court said the expert's documents created "a troubling impression" that the equity committee's valuation advisor was tied to a specific strategy and that the valuation analyst had already made up his mind.

Ultimately, the court found that the debtors acted in good faith and that the reorganization plan was appropriate. The plan was confirmed.

Lessons Learned

First, the facts and circumstances of each case rule. DCF is one of the more conventional and reliable methods used in bankruptcy, but the shipping industry's volatility made DCF unworkable in this case. And while NAV is not often used, it was the appropriate method for Genco.

Second, an expert's credibility is of utmost importance. If an appraiser is found by the court to have a "troubling" record and to have made up his mind about the valuation before the work was done, his credibility is shot.

When hiring a valuation expert, look for one who will approach each case with an open mind, whose neutrality is unquestionable and whose testimony will be credible. ■

Do you have questions about this case or other valuation cases? We'd be happy to discuss them with you.

Source: Business Valuation Update, November 2014

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What's It Worth … to Whom?

What is a business worth? It depends on a lot of things. A better question is: What is a business worth *to whom*?

Every valuation has a purpose, and different purposes require different standards of value. For example, if a business is being sold, its value may be different than if it were being assessed for estate planning purposes.

Some standards are mandated while others just make more sense in certain situations. Here's a quick look at three common standards of value:

1) Fair Market Value: The most common standard, fair market value is used in almost all state and federal tax matters. It is defined by the AICPA's *International Glossary of Business Valuation Terms* as the "price, expressed in cash equivalents, at which property or business would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, where neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."

2) Investment Value: This standard assumes that certain synergies exist between buyer and seller. It's typically defined as the value of a business or property to a specific buyer. For example, an investor may have specific requirements or expectations for an acquisition, like gaining a competitive edge or expanding geographic distribution of his or her product. If the target business meets those specific criteria, its value is enhanced.

3) Fair Value: This standard is generally used in cases of dissenting stockholders' disputes. Many states define fair value with respect to dissenters' shares as "the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects."

Before beginning a valuation engagement, the valuation professional works closely with clients to discern which standard is appropriate. ■