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#TMADIC
The Valuation of Distressed Businesses

Establishing a Framework and Avoiding Pitfalls
The Valuation of Distressed Businesses

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Key Points to Establishing a Framework and Avoiding Pitfalls

• Proper assessment of the turnaround thesis viability and cash flow projections
• Proper consideration of the capital structure
• Proper development of an appropriate discount rate
• Proper development of market multiples
Can the Company be Reorganized?

- Viability of turnaround thesis
- Management team execution capability
- Build up of projections consistent with turnaround thesis
  - Reasonableness, conservatism, milestones
- Adequate liquidity through reorganization
Determinants of Capital Structure and Ability to Reorganize

- Trade off between interest tax shields and the cost of financial distress
- The pecking order of financing choices
- The benefits and costs of financial slack
Factors that May Impact the Costs of Financial Distress, and a Company’s Ability to Reorganize

- Level of operating profits
- Company size
- Nature of assets
- Complexity of capital structure and make up of creditors
- Impact of economic cycles
- Length of revenue cycle
- Average product/service transaction size
- Quality and timeliness of financial reporting
- Leadership and human capital
- Labor relations
- Asset specificity
- Supplier concentration
- Quantity (number and dollar amount) of executory contracts
Tax Considerations

- Net operating losses
  - Age of net operating losses
  - Potential restrictions on utilization of net operating losses
    - IRC Section 382
    - Built in gains/losses
    - Special bankruptcy exceptions
- Cancellation of debt (COD) income
  - Tax attribute reduction
  - Taxation of COD income
- Tax basis and holding period
  - Transaction type
- Character of income
  - Asset type
- Other tax consequences of debt restructuring and asset foreclosures
  - Original issue discount (OID)
  - Recourse vs. nonrecourse debt
- Consolidated corporate group issues
- Value of tax shields implicit in the weighted average cost of capital (WACC)
Capital Structure for Valuation

• Using different capital structures of debt and equity can affect valuation
• Options:
  – Actual or anticipated at close of transaction
  – Industry average
  – Theoretical or optimal
Determining Theoretical Capital Structure

- Debt capacity analysis
- Theoretical bond ratings analysis
- Comparable company analysis
- Triangulate appropriate theoretical capital structure
Discount Rates

• Cost of equity
  – Modified CAPM
  – Duff & Phelps
  – Fama & French Three Factor Model
  – Consideration of company specific risk

• Cost of debt
  – Bond rating and yield to maturity

• Weighted average cost of capital (WACC)
  – Value of tax shields implicit in WACC
Comparable Company Multiple Analysis

- Multiples largely move up and down with the economic cycle
- Also driven by availability of capital, therefore, consistent with trends of leverage multiples
Distressed vs. Healthy Valuation Multiples

Note: Data points are based on the median; Data for 2008 and 2013 was unavailable