Valuation of distressed businesses

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The valuation of distressed businesses is a key element of many restructuring and workout situations. It is a decision-making tool which can help to shape the exit strategy and guide planning in terms of seeking to sell the business or assets or follow a restructuring process. Within a restructuring process, valuation is a central theme in negotiations to determine the ownership levels and level of required finance provision of the different stakeholder groups, which often have differing views and perspectives.

Where possible, distressed valuation follows the same principles and techniques as those used to value a healthy business, but the process needs to be more rigorous and reflect the realities of a distressed situation.

This chapter sets out the principles of valuing a business and then considers the specific challenges and nuances which need to be addressed when performing this exercise in a distressed environment. Each situation has its own individual characteristics and raises different issues, but with a structured approach a sensible result can be achieved.

1. Valuation techniques

When considering the appropriate valuation approach, one needs to decide whether the business is a going concern or whether best value will be generated from a break-up sale of the assets. A going concern valuation implies that the business will generate profit in the future on the assumption of sound management, suitable future investment and an appropriate funding structure.

Three basic valuation techniques are commonly applied to valuing a business:

- discounted cash flow (DCF);
- comparable multiples; and
- asset-based value.

Each technique has challenges that are amplified in a distressed situation. DCF, the purest valuation technique, depends on management's ability to produce reliable cash-flow forecasts. This is often extremely challenging in a distressed situation. The comparable multiples valuation methodology is applicable only if the business is generating a sensible level of pre-financing cost profit (earnings before interest and tax (EBIT)); earnings before interest, tax, depreciation and amortisation (EBITDA)) and asset-based values are likely to vary considerably between a going concern value and a break-up value.

As many of these techniques as possible should be used in order to build a valuation range for the business in question. A summary of the three valuation techniques is set out in the table below.

Table 1: Summary of valuation techniques

	DCF	**Comparable multiples**	**Asset-based value**
Basis	Values free cash-flow potential by discounting these back to a present value using a relevant cost of capital.	Applies the market valuation multiples of similar companies which either are quoted or have recently been acquired to the subject company's relevant financial metric.	Asset value in current use for a going concern, which often equates to book value or the current realisable market value of the assets in a liquidation scenario.
Rationale	The value of a company is the potential future cash flows discounted to reflect the opportunity cost of the total capital investment.	The assumption is that the market applies fair valuations to companies. The value of the subject company can be considered comparable to companies in the same sector with similar economics.	For a going-concern valuation in an asset-intensive business, single year profitability may not be an appropriate guide to value. In a liquidation, realisable asset value gives the best guide to value as there is no going-concern premium.
Requirements	Mid to long-term reliable cash-flow forecasts. Reasonable assessment of the relevant cost of capital.	Positive EBIT or EBITDA. Suitable comparable companies and transactions with similar economics to the subject company.	Market values for the assets.

continued overleaf

	DCF	Comparable multiples	Asset-based value
Applicable companies	All companies with future cash-flow visibility.	All companies with comparable data points.	Asset-intensive businesses.
Impact of distress	Cash-flow forecasts need to be rigorously challenged to assess deliverability. Discount rate needs to reflect increased risk. Potential for failure should be factored in.	Comparable data points must be thoroughly examined to assess level of comparability. Discount should be applied to reflect distress and risk.	Even in a going-concern sale, realisable value will be an important metric as it represents the buyer's downside position. Quality and level of continued investment in assets will impact on value. Important to assess whether third-party claims exist on each asset.

These techniques can all be used to generate either equity or enterprise valuations (ie, the combined value of both equity and net debt). When valuing a distressed business, it is more appropriate to consider the enterprise valuation, as it is unlikely that the current capital structure will remain in place and if the business is distressed then the equity is often of nil value. For this reason all of the valuation approaches we consider are for enterprise value.

2. Valuation process

The process for valuing a distressed business can be broken down into four steps:

- understand and evaluate the business and the impact of the current and potential level of distress;
- review and adjust historic and forecast financial data;
- perform valuation analysis;
- consider other items that can impact on value.

This four-step process should enable all relevant aspects of the business and its current situation to be factored into the valuation. Distressed valuation is often required in an accelerated timetable, so the use of this structure can help to ensure that key points are not missed.

2.1 Understand and evaluate business and impact of current and potential level of distress

When performing a valuation of any business, it is important to understand the quality and competitive positioning of the business in question. This reflects the importance of relativity in valuation. A business that holds a dominant position in its markets with high barriers to entry would typically carry a valuation premium to a weaker competitor that faces a high risk of substitution.

It is unusual to find a distressed business that holds such a dominant position and a review of its competitive position would be expected to highlight a number of risk areas which pose threats to future growth and prosperity.

Another key area when performing the initial review of the business is to assess the management team in terms of stability and quality. Distressed situations are often characterised by a great deal of management change and by management teams that have been unable to deliver on strategic goals. When a business is in distress, the ability of the management team to turn the business around and deliver on the business plan is critical. Without this, the achievability of a business plan can be highly questionable.

(a) Balance sheet v operational distress

Companies become distressed for many reasons and understanding the underlying causes is essential in order to arrive at a sensible valuation.

In some cases the company being considered is a well-run and viable business, but is overleveraged. The most common cause of overleveraging is major acquisitions – whether from the business' own leveraged buyout or from the acquisition of other businesses. In the years up to 2007, a large number of companies built up high levels of leverage with little headroom for underperformance.

Despite a sound underlying business, the leverage structure, repayment profile or refinancing requirements left many companies unable to service their debts as they fell due, making them technically insolvent. This scenario will be referred to as 'balance-sheet distress'.

Failure to tackle balance-sheet distress at an early stage through reset covenants, rescheduled debt repayments or some debt restructuring to reduce the current interest burden often leads to more significant operational issues because of lack of funds for investment in the development of the business.

The valuation of a business in early stage balance-sheet distress should not differ greatly from that of a healthy company, as alterations to the capital structure should eliminate the cause of distress rather than requiring changes to the operations of the business.

At the other end of the spectrum, there are businesses which are facing a significant decline in revenue or an unsupportable cost base due to changes in their market. Without significant operational restructuring, these businesses may not be viable as going concerns in the short or medium term. This scenario will be referred to as 'operational distress'. A good example of this is the UK high street retail market. This market grew its property footprint to meet continually rising consumer demand. It has since been hit not only by declining consumer spending but also by the switch to online purchasing. This has left many companies with leasehold estates with a significant number of loss-making sites. Companies in this market that are unable to take advantage of the switch to online and exit from loss-making sites are facing major operational distress often resulting in restructuring events.

Businesses in operational distress typically require significant investment to deliver their turnaround plans and present different valuation challenges from a healthy business. The valuation approach should be modified accordingly to reflect the cost and additional risk associated with the turnaround.

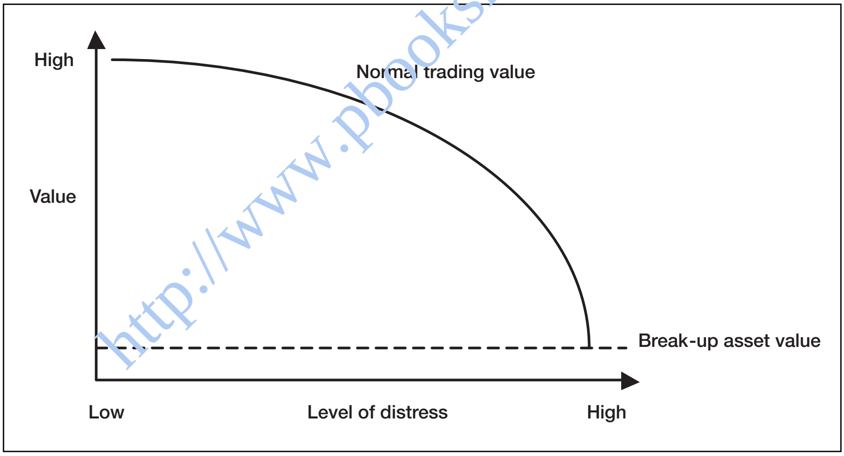
In the real world, of course, a distressed business will lie somewhere between the two extremes. It is a matter of judgement as to the detrimental impact that distress has had on a business and the level of discount that should apply as a result.

(b) *Distress and value*

Before considering how to value a distressed business, it is worth understanding why distress has an impact on value.

Figure 1 demonstrates the type of relationship that can typically be seen between the level of distress a business is facing and its potential valuation.

Figure 1 Relationship between level of distress and valuation



As the level of distress increases, the value of a business can be expected to fall rapidly as the risk of failure becomes a realistic possibility. This relationship can be explained by considering the following definition of the enterprise value of a business:

Real enterprise value = enterprise value – PV of costs of financial distress[1]

This equation recognises that there are real costs associated with financial distress and the risk of business failure. The risk of business failure increases rapidly with increasing distress and as such the costs of financial distress can also significantly reduce the real enterprise value.

1 Principles of Corporate Finance, Brealey/Myers, McGraw Hill.

The costs of financial distress are numerous and exist both when the business is at risk of insolvency and during a formal process itself.

Table 2 Examples of costs of financial distress

Operational and financial	Strategic and management
• detrimental credit terms • reduced access to lines of credit for overseas supply • higher incremental financing costs • fire-sale asset values • investment required for business recovery • professional fees.	• restraints on capital investment • project decision making focused on short-term rather than long-term value • distraction from running the business • conflicts of interest between stakeholders.

For these reasons, financial distress has a direct impact on valuation.

2.2 Review and adjust historic and forecast financial data

(a) Lies, damn lies and business plans

The one certainty of a company's business plan is that actual trading will always be different from the financial forecasts. This means that before the valuation analysis has started, a source of error has already been introduced.

When considering a distressed business, it is likely that the financial forecasts will have been prepared some time ago – potentially before the business had fully appreciated its true circumstances. It may even be the case that the person who prepared the forecasts is no longer with the company. It is therefore essential that the current management re-forecast based on current macro market issues and the company's own position. Any underperforming business with significant leverage is likely to have had an independent business review. This is an independent review of the deliverability of the financial forecast which highlights appropriate sensitivities and vulnerabilities to management's forecasts.

It is also possible that the results from the last financial year may no longer be an appropriate basis for a valuation, as they may no longer represent the new realities facing the business.

These facts mean that the financial forecasts and historic results need to be analysed more thoroughly than may usually be necessary for a healthy business. The analysis needs to drill down into the underlying assumptions to challenge them, in order to check that they still hold given the current conditions facing the business. This is especially important in the absence of an independent business review.

(b) Future net maintainable earnings

It is vital as part of any distressed valuation to review fully the financial forecasts and historic results to consider what adjustments need to be made to ensure that both the comparable multiples and DCF analysis use the appropriate financial data. These adjustments are all made with the objective of determining the company's future net maintainable earnings. The future net maintainable earnings reflect the earning capacity of the business when the impact of distress has been eliminated through either a refinancing or a formal insolvency process.

When considering the appropriate adjustments for the financial forecasts, only items which are ongoing in nature should be included. Any items that are considered situational, caused only by the current level of distress, should be excluded. Typical ongoing adjustments include:

- step reductions in sales: for example, due to changing market conditions or contract losses (eg, service companies supplying the public sector; construction companies following the credit crunch; music and DVD retailers following the switch to digital distribution);
- increased costs due to input cost inflation (eg, utility prices; metal commodity prices such as copper and platinum); and
- increased capital, maintenance or research and development (R&D) expenditure where these costs have been cut to preserve cash.

These ongoing adjustments also need to be taken into account for the historic results. When reviewing the historic results, additional consideration needs to be given to assess whether there are any one-off or non-recurring costs which can be eradicated once the company emerges from distress which need to be removed. Examples include:

- less favourable credit terms and discounts from suppliers;
- professional fees associated with restructuring or other corporate activity;
- above-market salaries and other distributions made to related parties in anticipation of distress; and
- profits or losses from asset sales.

Once these adjustments have been quantified and an assessment of the future net maintainable earnings has been made, the financials are in a position to be analysed for valuation purposes. Care should always be taken to ensure that any adjustments are supportable under scrutiny by third parties.

(c) Continued investment?

A tool used by management in distressed situations to conserve cash is to cut back on investment in the business. This may be through a reduction in capital expenditure, repairs and maintenance or R&D expenditure. No matter what category of cost is cut, this will almost certainly have a detrimental impact on the business if these cuts have been in place for any significant period of time.

Business plans typically underestimate the impact of lack of investment on the future profitability of the business. New investment takes time to implement and even longer to impact on profitability, and should be carefully considered as a sensitivity for the valuation.