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Guest Article

Determining a Distressed Debtor Company Discount Rate, Part 1

By Michael Pakter

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*This is Part 1 of a two-part article.*1 *This part discusses valuations of distressed debtor companies based on discounted cash flows and considers the impact of the date and stage of distress. Next month, Part 2 will describe how the financial analyst derives the cost of capital for a distressed debtor company.*

Financial analysis in contested bankruptcy proceedings often involves distressed business valuation issues. Whether a debtor company was solvent at a particular date is often critical in contested bankruptcy proceedings. The fair value of certain assets of the debtor company (or the business as a whole) is often pivotal in proving or disproving that solvency. (Generally, individual asset values will be determined based on the future cash flows expected from that individual asset.2)

Valuation issues are also important in other areas of the bankruptcy process. Valuations of assets (or the business as a whole) are often critical determinants of the viability of the plan of reorganization of a formerly distressed debtor company intending to emerge from bankruptcy. In bankruptcy proceedings, proper values are key to determine whether holders of secured claims are adequately protected, to determine the changing value of collateral over time, or to establish the "fresh start" financial reporting of a reorganized debtor company's assets and liabilities.

As the adversarial parties and their expert financial analysts defend their respective valuations—or reasonably equivalent values—a key element for the distressed (or formerly distressed) business as a whole (or selected asset classes) is determining a suitable discount rate. The purpose of this article is to provide guidance to the financial analyst regarding the proper discount rate to be applied to a distressed debtor company's cash flows for business valuation purposes.

For the purposes of this article, the author has defined:

A "distressed debtor company" as one with financing problems (difficulty in meeting obligations) and/or operating problems (apparent lack of operating success) of a magnitude such that it may seek the protection of the Bankruptcy Court.3

A "reorganizing debtor company" as a distressed debtor company going through a restructuring or reorganizing process; and

A "reorganized (formerly distressed) debtor company" as a debtor company allowed to resume business in a new form without the burden of loss-making operations and/or debt that existed prior to the bankruptcy proceeding.

This article assumes that the distressed (or formerly distressed) debtor company is being valued as a going concern.4 This article considers only valuation analyses in bankruptcy proceedings performed using discounted cash flows.5

Valuation based on discounted cash flows. A common method to determine the solvency of a debtor company is to calculate the present value of the debtor company's debt-free cash flow.6 The resulting present value is often referred to as the debtor company's market value of invested capital or its business enterprise value. The business enterprise value reflects the value of the debtor company's operating assets (net of its current operating liabilities—excluding debt).

Typically, to determine solvency, the value of the debtor company's long-term interest-bearing debt is subtracted from the invested capital value. Although other valuation methods in calculating solvency are frequently employed, this discussion summarizes the application of the discounted cash flow method.

To apply the discounted cash flow method, the financial analyst projects expected future cash flows through a discrete projection period, determines a terminal value (with the terminal value capitalized first), determines an appropriate discount rate, and applies that discount rate to both the discrete period cash flow and the terminal value.

Discounted cash flow valuation methods are commonly cited in business valuation literature, considered relevant and appropriate in many valuation settings, and recognized by bankruptcy courts. The financial analyst should assess the applicability of this method in each debtor company valuation situation.

The financial analyst should consider both the quality and quantity of information available before developing and applying a discounted cash flow method model. In applying the discounted cash flow valuation method, the analyst should be able to obtain and/or develop a credible projection of the debtor company's future cash flow.

The fact that the debtor company was or is distressed—or is in bankruptcy—affects the financial analysis of cash flows. A distressed business may have less data available regarding its cash flows than the average company—and that data may be more difficult to retrieve.

A distressed or bankrupt debtor company may have experienced significant turnover in personnel and/or loss of institutional knowledge. Distress may impact the quality and quantity of a debtor company's available financial information. The debtor company's accounting books and records may be in disorder.

The author experienced a situation where the password to the debtor's accounting books and records maintained using the QuickBooks software was no longer available after the controller quit her job. The author has experienced numerous situations where developing realistic future cash flow projections necessitated first reconstructing the true financial historical performance of the debtor company and its materially misrepresented financial reporting.

Proper identification of cash flows may have additional difficulties for a distressed, reorganizing, and/or reorganized debtor company. Cash flows may be measured at a consolidated parent level or at one or more subsidiary levels—but not all companies may be distressed, reorganizing, and/or reorganized using Chapter 11 of the Bankruptcy Code.

Taxes complicate the analysis. Tax carryforwards, if any, may result in the absence of taxes associated with cash flows for a period of time—at the parent and/or subsidiary levels. The financial analyst should be especially diligent in assembling the financial information needed for the valuation analysis.

The financial analyst should be careful to adjust historical data properly to take into account that the reorganization of the distressed business may have eliminated and/or restructured the entity's debt—and when that occurred. The financial analyst should ensure that the projected cash flows take into account the elements of the plan of reorganization and correlate with the discount rate determination—for example, pretax cash flows used together with pretax cost of capital elements, subsidiary-level cash flows giving rise to subsidiary-level values, debt service costs associated with correct levels of debt service, etc.

Point in time valuation is performed. "Courts will have to determine value on a case-by-case basis, but clearly value is to be determined in light of the purpose of the valuation and proposed disposition or use of the property."[7] (Also important in valuing the asset may be its benefit to the creditor.[8])

Generally, the Bankruptcy Code does not define the time at which the value is to be determined, leaving this matter to case-by-case interpretation and development.[9] In determining the date of valuation or the debtor company's stage of distress, the financial analyst should consider several issues on a case-by-case basis, including the purpose of the valuation in the bankruptcy proceeding; the prepetition and post-petition chronology of events; and the nature, timing, and extent of reorganization and restructuring efforts. It also may be useful to learn whether the industry as a whole—or the guideline

companies within that industry—has been reorganized and restructured, and when.

The financial analyst should consider whether the valuation is being performed for purposes of determining the adequate protection of a secured creditor, the solvency of the enterprise as a whole for avoidance actions, or the enterprise value for purposes of establishing the acceptability or feasibility of the plan of reorganization. Such considerations will guide the date(s) of the valuation(s), the information and/or documentation to be gathered, the cash flows to be measured, and the assets or businesses to be valued.

The financial analyst should be mindful that many sections of the Bankruptcy Code require valuations and/or prescribe the elements and/or conditions of those valuations. In several instances, case law has weighed in further on those specifics.10

The financial analyst should have an understanding of the chronology of events that led the debtor company to reorganize and/or seek the protection of the Bankruptcy Court. Dates in which one or more significant transactions took place—such as the date of a leveraged buyout, the dates of transactions that allegedly led to the debtor company being unable to pay its debts in the ordinary course of business, or the dates when specific locations were closed down—frame the date(s) of financial analysis and the corresponding historical or projected cash flows.

Valuations typically are performed on information known and knowable at the date of the valuation. What was known and knowable at a particular date, in itself, may drive the date(s) of valuation(s).

The financial analyst should consider the stage of a debtor company's distress and/or restructuring so that proper comparisons can be made to guideline metrics during the valuation process. Whether the debtor company is distressed or reorganized affects the financial analyst's assessments of risk and return, study of debt structure, and evaluation of sustainability of cash flows.

The date(s) of the valuation(s) depends on the purpose(s) of the valuation(s). For purposes of establishing plan acceptability or feasibility, the valuation is performed currently—at or near the date of the plan of reorganization, for a reorganized entity compared to other nondistressed businesses. The value of collateral for purposes of classifying debt in a plan of reorganization should be determined close to the effective date of the plan and/or plan confirmation.11

For an avoidance action, the valuation is performed historically—at or near the date(s) of a transaction that may be alleged to have rendered the debtor insolvent. To determine the adequate protection of a secured creditor, the valuation may be needed at the petition date, the time the secured creditor sought relief from the automatic stay, or close to the time of the hearing.

There is considerable uncertainty as to the date the creditor is entitled to adequate protection and the related date on which the valuation should be made: as of the petition date or as of the date the creditor first asked for adequate protection. Courts have held that the creditor is entitled to protection of the value of its collateral: (a) as of the petition date; (b) as of the date the right to adequate protection commences; or (c) as of the date the creditor first sought relief for adequate protection.[12]

While the financial analyst should perform the valuation as of the date of any challenged transfer, the courts have recognized that businesses do not prepare daily balance sheets. The *Litigation Services Handbook*[13] notes that the Courts allow for retrojection spanning the gap between a transaction date and the balance sheet date for the solvency determination.

In a retrojection analysis, the financial analyst should demonstrate that no material changes in the financial condition of the debtor company occurred between a date when solvency (or insolvency) can be established and the date of the challenged transaction, such that the condition of solvency (or insolvency) established at a particular measurement date can be inferred for the date of the challenged transfer.

Appropriate discount rate. Generally, the selected discount rate reflects the debtor company's weighted average cost of debt capital and equity capital.[14] Solely for the purposes of this article, the author has defined "debt capital" as capital that the company raises by taking out a loan to be repaid at a future date regardless of the company's financial position and "equity capital" as invested money that is not repaid to investors during the ordinary course of business—and cannot be repaid while the debtor company is insolvent.

Generally, the debtor company's debt-free cash flow represents its cash flow from operations less its investing cash flow. The greater the risk of realizing the debtor company's projected cash flow, the higher the selected discount rate. The mathematical effect of increasing the discount rate is to reduce the present value of the debtor company's cash flow. Generally, a discount rate that is too low may reflect a bias toward solvency, while a discount rate that is too high may inappropriately indicate that the debtor company is insolvent.

Generally, selecting the discount rate involves the use of the capital asset pricing model or some other cost of equity capital model. If the debtor company is privately owned, the financial analyst may consider guideline public companies during the process of estimating the cost of equity capital.

When using such guideline companies, the financial analyst should be careful to select companies that provide meaningful valuation guidance from an investment risk and expected return perspective—one that properly takes into account the distressed, reorganizing, or reorganized nature of the debtor company.

Another procedure for considering projection performance risk is to use a probability weighted set of projected scenarios: High probability scenarios will get more weight than those having a low probability, resulting in a probability weighted cash flow analysis. The financial analyst should appropriately apply a discount rate that takes risk into consideration. These issues are discussed in additional detail in Part 2 of this article.

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1 The author gratefully recognizes the training and materials provided by and the textbook written by Grant W. Newton, professor emeritus of accounting at Pepperdine University in Malibu, Calif., and executive director of the Association of Insolvency and Restructuring Advisors, and acknowledges that significant portions of this article rely extensively on materials extracted from Volume 1 of *Bankruptcy and Insolvency Accounting—Practice and Procedure*, written by Professor Newton.

2 Extracted from *Bankruptcy and Insolvency Accounting—Practice and Procedure,* 7th ed. Vol. 1, by Grant W. Newton, at page 555.

3 Extracted from the Newton textbook at page 745.

4 The author recognizes that certain valuation analyses in bankruptcy proceedings can or will be based on the liquidation premise of value (or even that part of the business that continues while parts are liquidated). This merely adds to the complexity of the moving parts that the financial analyst should take into account in the performance of his or her work.

5 The author recognizes that other valuation methods exist. This article does not attempt to discuss or differentiate between the fair value versus a fair market value standard of value and, among other issues, ignores discounts for lack of control and/or for lack of marketability.

6 This section, and subsequent paragraphs, extracted from *Solvency Analysis: A Primer on Applying the Discounted Cash Flow Method,* by Robert Reilly, at page 115.

7 Extracted from the Newton textbook at page 558. Also see *Barash v. Public Finance Corp.*

8 Extracted from the Newton textbook at page 559.

9 Extracted from the Newton textbook at page 555.

10 A list of Bankruptcy Code sections with value mentions may be found in the Newton textbook at pages 573-574.

11 Extracted from the Newton textbook at page 560(b).

12 Extracted from the Newton textbook at page 557.

13 Extracted from *Litigation Services Handbook—The Role of the Financial Expert,* authored by Roman L. Weil, Peter B. Frank, Christian W. Hughes, and Michael J. Wagner, The *Litigation Services Handbook,"* at Chapter 22, page 31, Section 22.3(ii).

14 Extracted from the Reilly textbook at page 115.

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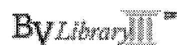

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