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EDITORIAL

Valuation Disputes in Restructurings: More to Come

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Introduction

One of the most fundamental questions in any restructuring is what is the value of the underlying business? The tranche of the capital structure in which value 'breaks' will determine the likely strategies adopted by the various classes of capital provider to key questions on a restructuring – who will provide any new money requirement?, on what terms? and how can the solution be delivered?

For the most part, the wave of private equity buyouts conducted between 2005 and 2007 involved sound businesses which continue to operate profitably at the operating level (i.e. before interest charges). However, a high proportion of these businesses remain significantly over-leveraged.

Quarter four 2008 saw a double hit to valuations – not only did share prices and other risk assets fall, but the shock to business confidence saw a significant de-stocking/reduction in demand hitting underlying operating profits of many businesses. If valuation is expressed as a multiple of a measure of profits (e.g. EBITDA), then both elements of this valuation equation fell sharply.

As a result, the enterprise value (i.e. the value of the underlying business on a debt free basis) fell sharply, often to a point where the value of equity, mezzanine and junior debt was fundamentally impaired.

The junior creditor perspective

This value break, when coupled with new money requirements, meant that equity and junior debt providers were not prepared to put in new money at their current level within the capital structure.

Rather, offers of new money by private equity or mezzanine houses have often been made on a 'super senior' basis i.e. ranking ahead of the existing senior debt.

Alternatively, offers of new money by junior creditors or equity providers have been predicated on the basis of a significant de-leveraging via a write off of senior debt as part of a fundamental balance sheet restructuring. In practice, the reluctance of senior debt providers to take such fundamental write-offs, coupled with the logistical challenges of co-ordinating large, diverse syndicates has often meant that senior debt providers have ended up providing the new liquidity themselves.

With equity market indices up by an average of approximately 60% since the trough in the first half of 2009, a sustained rebound in pricing of risk assets is likely to have a significant impact on ongoing restructurings. The most obvious impact is that value breaks are moving back down the capital structure back towards the mezzanine and equity tranches.

This recent uplift in valuations has impacted behaviour of junior creditors who now perceive that their economic interest has returned and could grow significantly in future. In practice, this has meant a reluctance to 'hand over the keys' to the senior lenders and a fight to retain potential upside.

'Extend and pretend'

Perhaps the most common theme seen in restructurings in the last year has been the difficulties in executing a fundamental balance sheet restructuring. Instead we have seen a preponderance of temporary solutions, variously called 'sticking plaster' or 'extend and pretend' solutions whereby covenants have been re-set, pricing on senior facilities increased and the term extended. This has often occurred even where the resulting debt structure may not be sustainable longer term, particularly once the interest rate cycle turns up.

This has been driven by a co-incidence of factors including resource constraints and internal issues at many banks, combined with an incentive to delay and hope for increases in asset values on the part of out of the money junior creditors and equity sponsors. This, however, cannot last forever. Eventually any one of a number of factors will force stakeholders back to the table. This could be a future downturn in trading,

Notes

1 The views expressed in this article represent those of the author and are not necessarily the views of FTI Consulting.

perhaps coupled with a new money requirement or the need to address a looming bullet refinancing.

The senior debt perspective

Where value breaks within the senior debt, senior debt providers are directly exposed to the downside risks. If they are the ones funding the business and meeting new money requirements, they are often looking to take the upside potential as well. Increasingly, this means through direct equity ownership rather than just small amounts of warrants that essentially merely 'sweeten' the senior debt position.

This is now the case not just for those turnaround and distress focussed investors pursuing 'loan to own' strategies but also for the mainstream commercial banks. Having added to the workout teams and added people with private equity backgrounds, senior debt providers are increasingly willing and able to act as equity owners – although this is not to underestimate the challenges of co-ordination where a large bank syndicate is equitised by a debt for equity swap, leaving the company without a clear lead equity owner.

So, it seems likely that there will be an increasing number of battles for control involving fundamental valuation disputes during 2010. This will involve a series of transactions by which private equity sponsors and/or junior creditors that are not part of a new money solution will be dis-enfranchised by the senior debt providers.

Structural issues

In the UK, there are two commonly used mechanisms by which out of the money stakeholders can be 'squeezed out' by senior creditors: the scheme of arrangement and the pre-packaged administration.

A scheme of arrangement is an agreement between a company and either the holders of its securities or its creditors which is approved by a court. A scheme of arrangement is company-led and therefore requires the directors to take an active part in leading its execution.

The term pre-packaged administration or 'pre-pack' is used for the sale of the business and assets of a company, which is agreed prior to the initiation of a formal insolvency proceeding and is executed immediately following the appointment of an administrator. The administration process is led by an Insolvency Practitioner (IP) but the formal insolvency lasts only momentarily as the company is immediately sold on a pre-arranged basis. This avoids the damage to a business which can arise from a more lengthy trading administration where suppliers, employees and customers may well all take flight.

However, difficulty in conducting pre-packs can be encountered when the senior lender group cannot agree on an appropriate process. Thus schemes of arrangement have frequently been combined with a pre-packaged administration to prevent the transaction being blocked by a minority of senior lenders and to effect the transfer of the business to a newco predominantly owned by senior creditors, leaving 'out of the money' junior creditors in the insolvent rump.

Valuation issues on pre-packs

There has been adverse publicity associated with a number of pre-packaged administrations where creditors have been impacted by administrations which have often been used tactically to divest liabilities so that the business can emerge under new ownership. Examples where directors have been the owners of the newco which acquires the business out of a pre-pack have given rise to increasing scrutiny on the valuation issues in such cases and whether the value paid by the new owner fairly reflects the value of the business and hence is fair to creditors.

The issue of the Statement of Insolvency Practice 16 (SIP 16) in early 2009 has set out requirements that an Insolvency Practitioner has to meet with regards to disclosure of what valuation evidence has been obtained to support the transaction.

The IP is required to disclose information to creditors detailing any market-testing activities by the company or administrator, valuations obtained for the business or the assets of the business and also any alternative courses of action that the administrator considered with an explanation of the financial outcomes of those alternatives. This provides junior creditors with more information than in the past with which potentially to challenge the IP.

UK squeeze-outs – the first round

In the first half of 2009, we saw a number of UK senior debt-led financial restructurings which utilised schemes of arrangement and/or pre-packs to effect restructuring transactions which disenfranchised junior lenders. These restructurings include Countrywide, McCarthy & Stone, Crest Nicholson and British Vita.

These companies had underlying businesses in highly cyclical sectors such as construction, real estate and chemicals. These were therefore early casualties of the economic downturn. In such cases, given market conditions at the time, it would have been difficult to argue that value did not break within the senior debt.

However, as is demonstrated by the IMO Carwash case (and the MyTravel case in 2004), the door remains open for junior creditors at risk of disenfranchisement via a scheme of arrangement to show that they have a genuine economic interest, based on the valuation of the business and the prevailing capital structure.

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The IMO Car Wash case

This case has provided the most recent and high profile test of a number of key questions for valuation on restructurings.

IMO Car Wash operates a retail car wash business. The group had two major secured debt facilities, a senior credit agreement and a mezzanine credit agreement, of which approximately GBP 313m and GBP 119m were outstanding respectively.

The senior lender group proposed a scheme of arrangement combined with a pre-packaged administration involving the transfer of the business and assets of the existing group which would, in effect, wipe-out the outstanding debt owed to the subordinated lenders by leaving them with a claim against a company without assets. The senior lender group proposed to novate an estimated GBP 185m of debt to the new group and the senior lenders would receive the majority of the equity in the newco.

The justification offered by the company and the senior lender group was that the mezzanine lenders had no economic interest in the group because the value of the business and assets was less than the value of the senior debt. The mezzanine lenders were not parties to the scheme and hence had no vote on it but nevertheless challenged the scheme in the High Court.

The mezzanine lenders did not accept that the value of the group's business was less than the senior debt but argued that even if that was the case now, the scheme unfairly deprived them of the chance to benefit in future from an increase in the value of the Group whereby value could exceed the senior debt.

During the case there were extensive discussions about the use of various valuation approaches put forward by the parties respective valuation advisers.

A valuation undertaken on behalf of the company and the senior lenders valued the group using a discounted cash flow approach, multiples of comparable quoted companies and on M&A transactions and a leveraged buyout analysis (assessing the price a financial purchaser could afford to pay given a certain required rate of return). This valuation concluded that a purchaser would not pay more than GBP 265m for the business.

Concurrently, the company's financial adviser conducted a sale process in order to market test the pricing, which process only produced one indicative offer, which reflected an enterprise value of GBP 150m to GBP 188m on a cash and debt free basis.

The senior lenders approach to valuation was also supported by the fact that the senior debt was trading at a significant discount to its par value, at approximately 60p in the pound.

Against this, the junior lenders valuation adviser (LEK Consulting) carried out a 'Monte Carlo simulation' method of valuation. This was a complex, probabilistic financial model which mathematically modelled a range of future outcomes. The LEK Consulting report sought to demonstrate that in a number of possible future scenarios, the value of the business could exceed the value of the senior debt.

The court was ultimately not persuaded by, and was critical of, the valuation arguments put forward on behalf of the mezzanine lenders and dismissed the objections of the mezzanine lenders.

The key implications of the case for valuations on restructurings were as follows:

- *Engagement.* The court criticised the mezzanine lenders for not having engaged in a substantive valuation debate ahead of the court process. The lesson is that junior creditors need to appoint valuation advisers earlier, make their case robustly and more transparently and share their findings with other stakeholders.
- *Transparency of assumptions.* The court criticised the mezzanine valuation report as 'obscure' on the basis that it was not possible to understand all of the key underlying assumptions and methodology.
- *Real world versus theoretical value.* In a number of ways, the court showed a preference for arguments based on accepted methodologies, on current market values as evidenced by a real M&A process and the price at which the senior debt was trading in the market rather than on more technical, theoretical arguments.
- *Value now versus value in the future.* The court supported the argument that the key consideration was the value (measured by what a purchaser would pay) of the business now and not the potential value at some point in the future.
- *Going concern versus liquidation value.* In this case, where the group was profitable at the operating level but over-indebted, the court confirmed that it was appropriate to consider valuations of the business on a going concern basis.

European cases

There have also been a number of noteworthy recent continental European cases where senior lenders have taken control and/or squeezed out junior classes of capital. These include Monier (formerly Lafarge Building Materials) where the former senior lenders are now the owners of the group.

The restructuring of Schoeller Arca Systems ('SAS') was another relevant recent European case. In September 2009, the Dutch court gave its approval in respect of a private sale of the shares in the Dutch top holding company of SAS, by way of an enforcement of a Dutch law share pledge. This was the first Dutch court ruling in respect of a Dutch pre-pack whereby

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an enforcement sale of a Dutch holding company was pre-agreed between a buyer, the company and its senior lenders.

Conclusions – more disputes to come?

One feature of this downturn has been the challenges and time lags involved in executing fundamental balance sheet restructurings and the resulting preponderence of temporary solutions.

This has left a huge set of leveraged buyouts from 2005-2007 where the capital structure issues have in large part been deferred rather than addressed. With the possibility of further adverse economic developments and equity market volatility to come, there remains scope for a significant number of battles for control of companies in the context of restructurings.

We believe that the focus could increasingly turn away from the first wave of highly cyclical businesses which were hit early in the downturn, towards battles for control over 'good businesses with bad balance sheets'.

With high stakes and with volatility in asset prices, the question of 'where does the value break?' will increasingly be subject to dispute – either inside or outside of a court process.

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International Corporate Rescue

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