New York Law Journal
A NEW YORK LAW JOURNAL SPECIAL SECTION
Corporate Restructuring And Bankruptcy
An ALM Publication
WWW.NYLJ.COM
MONDAY, SEPTEMBER 15, 2014

Value Judgments: **Applying the Proper Valuation** For a Company's Industry

BY ADAM C. ROGOFF, P. BRADLEY O'NEILL AND ANUPAMA YERRAMALLI

When Genco Shipping & Trading Ltd navigated its international operations through a $1.4 billion financial restructuring, one primary driver chartered its course—understanding the proper valuation of a drybulk shipping company. Drybulk shipping is a competitive, highly fragmented industry with low entry barriers. It mirrors the classic economic model of "perfect competition." This dynamic is compounded by inherently volatile vessel charter rates, which adversely affect predicting reliable projections over time. Against this backdrop, Genco and its sophisticated creditor groups—consisting of numerous banks and institutional investors—successfully negotiated a Restructuring Support Agreement (RSA) and prepackaged Chapter 11 plan and, in doing so, understanding that the more "commonly used" restructuring valuation methodologies were not accurate benchmarks. Instead of relying upon (1) a discounted cash flow (DCF) analysis, (2) a comparable company approach, or (3) a precedent transaction approach, Genco focused on the fleet's net asset values—NAV—in its negotiations. Projections were used to assess the feasibility of any restructuring for liquidity purposes—not to establish value.

ADAM C. ROGOFF *and* P. BRADLEY O'NEIL *are partners, and* ANUPAMA YERRAMALLI *is an associate, at Kramer Levin Naftalis & Frankel.* RACHAEL RINGER, *an associate, assisted in the preparation of this article. The authors, with Blackstone, represented Genco and its subsidiaries in the restructuring and prepackaged Chapter 11 cases mentioned in this article.*

This key understanding of industry-tailored valuation allowed Genco to foster consensus on the terms of a $1.2 billion conversion of debt to equity, raise $100 million of new liquidity, and restructure $250 million of remaining secured debt. Conversely, the *failure* of certain equity investors to appreciate the economic underpinnings of drybulk shipping led to a hotly contested valuation battle—a litigation that could have been avoided had the equity committee recognized that valuation in restructuring should take into account the undercurrents of the company's industry. Giving substantial weight to the industry-specific NAV approach, the bankruptcy court overruled the equity com-

mittee's confirmation objections, keeping the restructuring on course. This article discusses the importance of applying the optimal valuation methodology for the debtor's industry, whether or not it is a "commonly-used" restructuring methodology.

Uses and Timing of Valuation in Bankruptcy

Valuation is often a key component of restructuring, arising at different stages of a case and for varying purposes. For example, valuation is central to the use of cash collateral or debtor-in-possession financing to adequately protect against diminution in value of any collateral. Fair market value may apply as of the petition date for debtor-in-possession financing, whereas the difference between value on the petition date and the hearing date may apply for the use of cash collateral.[1] During a bankruptcy case, a creditor may argue that it is oversecured and entitled to postpetition interest; here, valuation is determined based on the time period of the creditor being oversecured.[2] Avoidance actions, such as preferences and fraudulent transfers, require proof of insolvency or reasonably equivalent value measured at the time of the potentially avoidable transfer.[3] Valuation can also drive an entire case outcome, such as the value of a reorganized company under a plan. Here, valuation is measured as of the confirmation date.[4] Where a restructuring plan is nonconsensual ("cram down"), it must be "fair and equitable" to dissenting class—a valuation dependent analysis.

Typical Valuation Methodologies

Three commonly-used methodologies for valuing a distressed company are (1) DCF, (2) comparable companies, and (3) precedent transactions. While these methods may be prevalent, they may not best apply. To provide a "sanity check,"[5] more than one methodology should be analyzed, although the most credible methodology depends on the particular industry.

Briefly, DCF estimates the net present value of a company by adding the present value of two assumed future cash flow streams: (1) the projected unlevered cash flow for a number of upcoming years, discounted to present value using an estimated discount rate based upon the company's weighted average cost of capital, and (2) projected cash flow for the period thereafter in perpetuity, known as the "terminal value." The total enterprise value (TEV) is determined by adding the two present values of the assumed future cash flow streams. While DCF is touted as reliable because it is forward-looking, it is subject to the volatility of underlying projections and significant assumptions such as terminal value and discount rate. Nor does DCF account for changes in capital expenditures or the impact of the restructuring. In fact, in the *Adelphia Communications* Chapter 11 case, the bankruptcy court specifically noted: "DCF works best (and, arguably, only) when a company has accurate projections of future cash flows."[6]

The "comparable company" approach analyzes the value of comparable peer firms and uses their metrics to project the value of the subject company. Values are standardized using one or more common variables (including revenue, earnings, cash flow or any common metric that drives cash flow) with the expert applying a multiple of the financial metric(s) that yields the market's valuation of the comparable companies. Comparable company analysis can be consolidated (looking at comparables for the entire company as a whole) and sum-of-the-parts (looking at individual lines of businesses and aggregating those results to estimate the TEV). Selecting the appropriate multiple is key to this analysis; however, these multiples require adjustment for liquidity constraints, leverage, management's capabilities, and profitability between the comparable and subject company.

The "precedent transactions" methodology applies multiples derived from comparable companies from their purchase prices in past mergers and acquisitions. This method analyzes precedent transactions (including control premiums, operational synergies and hostile transactions) and the current financial environment. This methodology requires the debtor to examine change-in-control (stock) transactions that allow for apples-to-apples comparison between the companies sold and the subject company. Similar adjustments for multiples can be required.

Know Your Industry: Genco as a Case Study[7]

As a leading provider of international seaborne transportation services for drybulk cargo (including iron ore, coal, and grain), Genco operates in a highly competitive shipping industry. As with other shippers, Genco fell victim to significant economic downturn affecting the drybulk shipping sector, coupled with a highly leveraged balance sheet that included three separate secured credit facilities aggregating $1.3 billion, plus unsecured convertible note debt of $125 million (plus trade and other operating debt).

The industry-specific NAV methodology formed the basis of the company's restructuring negotiations with its creditors—parties with (or whose advisors had) significant experience in the drybulk shipping industry. Despite the fact that NAV was not a common "restructuring" valuation methodology, the company and its principal creditors recognized the use of NAV in the industry. Why was this relevant? The drybulk shipping is highly competitive and fragmented in nature, with low barriers to new entry, and using essentially commoditized assets. With an active market for vessel sales, the net asset value of vessels, based upon appraisals, largely (or entirely, if no other assets) forms a shipper's value. In effect, asset values are established weekly as vessels trade.

Using NAV of vessels (plus specific additional non-vessel assets), Genco[8] calculated its total distributable value as between $1.36 billion and $1.44 billion—less than its total liabilities. Despite this insolvency, Genco negotiated concessions from its creditor supporting a prepackaged plan leaving trade claims unimpaired and even providing a voluntary distribution to equity through new warrants. Once the bankruptcy case was filed, the U.S. Trustee appointed a three-member equity committee, which disputed Genco's valuation, asserting solvency.

The equity committee's analysis suffered from misunderstanding the industry, arguing the use of "traditional" valuation methodologies, and largely disregarding NAV. The equity committee gave the most weight to its DCF analysis, followed by comparable companies, NAV, and precedent transactions, in descending order. As a "sanity check," Genco likewise analyzed each of these alternatives. Unsurprisingly, the competing analyses differed materially based upon selected data inputs, including projections.

However, the equity committee disputed the relevance of NAV and vessel appraisals to establish "going concern" value. While Genco's proposed fleet appraisal values were not contested, the committee argued that Genco was undervalued because the debtors did

not include intangible points of value such as (1) the corporate franchise, (2) management, and (3) future cash flows. It argued that each of these sources of value reflected "hallmarks of true going-concern enterprise valuations derived from the traditional [valuation] methodologies" and their inclusion would significantly increase the value of the company in equity's favor. Genco argued that vessel appraisal values *assume* that the vessels will be in use and earn a market hire rate; in other words, in this industry, vessel appraisal values already included future market earning capacity.

As part of its "sanity check," for comparable companies, Genco proposed six companies, analyzing them using both a TEV/NAV analysis and a TEV/EBITDA analysis. The equity committee urged the court to exclude two of the comparables utilized by Genco due to their size, TEV, and corporate profile. Excluding these comparables (which had the lowest multiples under both a TEV/NAV analysis and a TEV/EBITDA analysis) resulted in a higher calculation of value for the company by the committee. With respect to the precedent transactions analysis, the committee urged the court to look not at "fleet sale" transactions, but rather public change-in-control transactions. In conducting this analysis, the committee asked the court to "consider what buyers would pay for a full business, inclusive of an operating platform, management, and expected future cash flows, not simply the value of the assets." Genco proposed an analysis based on fleet sale transactions given the relative absence of public change-in-control transactions in the industry. This absence recognized that buyers would not pay a premium to acquire control of an existing dry-bulk shipper when the requisite assets (vessels) traded in the market and could be acquired readily; hence, the low barriers to new entry into this industry. Finally, the committee urged the court to afford the most significant weight to a DCF analysis dependent upon future rate projections. This analysis resulted in the committee's highest value. Genco disputed the reliability of projections to establish value because of the inherent volatility of dry bulk shipping rates—a fact ultimately acknowledged even by the committee's experts.

Genco's prepack case contemplated a 45-day confirmation milestone under the RSA. The bankruptcy court granted a 30-day extension to allow the committee to undertake discovery and dispute valuation. Following extensive discovery and a four-day trial (involving the testimony of eight live fact and expert witnesses), the bankruptcy court issued a 60-page decision endorsing Genco's use of NAV given the specific characteristics of the drybulk shipping industry and the industry's acceptance of this methodology as the proper means by which similar companies should be valued. However, while NAV was to be given "substantial weight given the nature of the drybulk shipping industry," the court also analyzed the other methodologies, holding that a comparable companies analysis was likewise useful in determining value, but that a precedent transactions analysis was of "limited utility."[9] But, recognizing the "highly speculative nature of rate projections for the drybulk shipping industry," the court found that the DCF analysis was an inappropriate means by which to value an entity such as Genco.[10]

In its analysis, the bankruptcy court addressed the propriety of the data inputs for the other proffered methodologies, largely agreeing with Genco's approach on comparable companies. For the precedent transactions analysis, the court examined the few public change-in-control transactions (stock acquisitions) that took place in the preceding 10 years in dry-bulk shipping. The court observed that these transactions were generally consummated at or around NAV, observing that a very recent change-in-control transaction was consummated *at* NAV. Because there were only three transactions that were relevant to this analysis, the court found that the benefits of this analysis were relatively limited. However, as noted, the absence of numerous stock acquisitions reflected the specific nature of the shipping industry, where change-of-control transactions are usually unnecessary since acquirors can typically purchase vessels individually or in bulk.[11] In the end, all valuation methodologies demonstrated Genco's insolvency, and the court confirmed the Genco's as-proposed prepackaged Chapter 11 plan.

Conclusion

The morale of this case study is two-fold—perhaps even two sides of the same coin. First, the appreciation by the company and its various creditor groups and their advisors of the proper valuation approach in the dry-bulk shipping industry greatly expedited the financial restructuring and deleveraging process. The parties negotiated and documented a complex restructuring in a matter of months—all based upon a common understanding of NAV. On the flip side, the Chapter 11 prepack was (unnecessarily) delayed by a small group of equity investors whose strategy relied upon using largely inapplicable "traditional" valuation methodologies, virtually ignoring the *industry's* standard. However, as *Genco* supports, valuation should take into account the industry within which the debtor operates. While using the so-called "traditional" restructuring methodologies may be helpful to confirm the reasonableness of the industry-accepted methodology, overreliance upon such traditional approaches can be misleading. Valuation fights—particularly those underlying a Chapter 11 plan—can be "bet the company" litigation. Whether governing the soundness of the initial investment decision, the posture taken during negotiations, or developing a litigation strategy, research the company's industry. If you want to keep your business afloat, it helps to know your ship.

1. See id. at 590 n.29 (citing 4 Collier on Bankruptcy ¶ 506.03[7][a][iv] for rule that "[i]n general, courts typically hold that, for purposes of adequate protection, the value of the collateral is to be determined either as of the petition date or as of the date on which the request for adequate protection was first made."); *In re Mosello*, 195 B.R. 277, 286 (Bankr. S.D.N.Y. 1996). Compare with *In re Ritz-Carlton of D.C.*, 98 B.R. 170, 173 (S.D.N.Y. 1989).
2. See *In re SW Boston Hotel Venture*, 748 F.3d 393, 405 (1st Cir. 2014); *Matter of T-H New Orleans Ltd. P'ship*, 116 F.3d 790, 798 (5th Cir. 1997).
3. *In re Iridium Operating*, 373 B.R. 283, 342 (Bankr. S.D.N.Y. 2007); *In re Bennett Funding Grp.*, 232 B.R. 565, 570 (Bankr. N.D.N.Y. 1999).
4. *In re South Side House*, 451 B.R. 248, 262 (Bankr. E.D.N.Y. 2011). The minority view is that valuation is measured as of the Petition Date.
5. "Sanity checks" refer to the use of an alternative methodology to test a proposed valuation.
6. *Adelphia Recovery Trust v. FPL Group (In re Adelphia Commc'ns)*, Case No. 02-41729 (REG), 2014 Bankr. LEXIS 2011, at *56 (Bankr. S.D.N.Y. May 6, 2014).
7. *In re Genco Shipping & Trading Ltd.*, Case No. 14-11108 (SHL) (Bankr. S.D.N.Y.). See Memorandum Decision on Confirmation Issues found at *In re Genco Shipping & Trading Ltd.*, Case No. 14-11108 (SHL), 2014 Bankr. LEXIS 2854, (Bankr. S.D.N.Y. July 2, 2014) (the Decision).
8. Value references for Genco includes various vessel-owning and other specific subsidiaries.
9. Decision, at *22.
10. Id.
11. Id. at *46-51.

Reprinted with permission from the September 15, 2014 edition of the NEW YORK LAW JOURNAL © 2014 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited. For information, contact 212-457-9411 or reprints@alm.com. # 070-09-14-17