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VALCON 2021 Fundamentals Course

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2021

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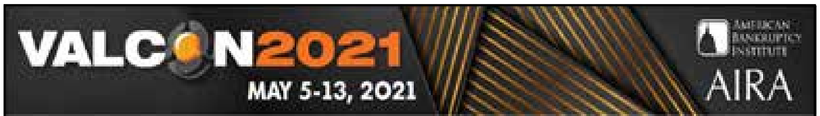

Valuation Fundamentals

Presented by:

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Live on-line presentation date: May 5, 2021

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AGENDA

Session 1:	I.	Overview
	II.	Definitions of Value
Session 2:	III.	Steps in the Business Valuation
Session 3:	IV.	Approaches to Valuation – Income
Session 4:	V.	Approaches to Valuation – Market
	VI.	Approaches to Valuation – Asset

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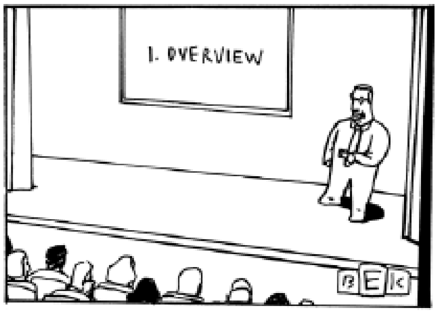
I. OVERVIEW



"First, I want to give you an overview of what I will tell you over and over again during the entire presentation."

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I. OVERVIEW

Learning Objectives

- Define concepts of value
- Determine the appropriate application of each concept
- Outline the steps in performing a business valuation
- Identify the approaches to performing a business valuation
- Review the steps in performing a business valuation under:
  - The income approach
  - The market approach
  - The asset approach

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POLLING QUESTION 1

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I. OVERVIEW

Overview

- Valuation is, if not an art, then, at best, not an exact science
  - For example, opposing parties in litigation valuing the same asset
  - IRS Revenue Ruling 59-60 actually uses the word "prophecy"
- To value a company, one would typically use multiple methods
  - Best case, valuation methods converge around the "answer"
  - Can use different methods within the valuation of a company to value different assets of that company
- Certain methods have varying degrees of validity and/or acceptance

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I. OVERVIEW

Uses of Valuation in Bankruptcy

- Assessing viability of the debtor's operations and the prospects for reorganization
- Valuing business units or other assets to sell to generate liquidity or rationalize the business
- Advising creditors on the potential value of the distressed assets and settlement value
- Evaluating asset sale prices and offers
- Estimating collateral values

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I. OVERVIEW

Uses of Valuation per the Code

- **§ 506(a)(1) – Determination of secured status**

An allowed claim of a creditor secured by a lien on property…is a secured claim to the extent of **the value of such creditor's interest**….Such value shall be determined in light of **the purpose of the valuation** and of **the proposed disposition** or use of such property…

- **§ 1129(a)(7)(A)(ii) – Confirmation of a Plan**

The court shall confirm a plan only if…each holder of a claim or interest of such class…will receive…value…that is not less than the amount that such holder would so receive or retain if **the debtor were liquidated under chapter 7**….

- **§ 548(a)(1) - Fraudulent transfers and obligations**

The trustee may avoid any transfer…if the debtor voluntarily or involuntarily…received less than a **reasonably equivalent value** in exchange for such transfer or obligation

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POLLING QUESTION 2

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II. DEFINITIONS OF VALUE

"With the doubloon, you've got the intrinsic value of the metal plus the numismatic considerations."

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II. DEFINITIONS OF VALUE

Definitions of Value – Fair Market Value

The price at which the property would change hands between a willing buyer and willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell; both parties having reasonable knowledge of relevant facts.

IRS Revenue Ruling 59-60

The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

American Society of Appraisers ("ASA")
Business Valuation Standards

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II. DEFINITIONS OF VALUE

Other Definitions of Value

- **Fair Value**
  - State statutory definition and court case precedent
  - Value immediately prior to the corporate action
  - Fair value and fair market value diverge in some states if a minority shareholder is oppressed in a controlling interest transaction
- **Investment value**
  - Value to a particular investor
  - May reflect synergies
- **Acquisition value**
  - Buyer specific economic benefits/synergy
- **Intrinsic Value**
  - Value based on fundamental factors
  - "True worth" concept

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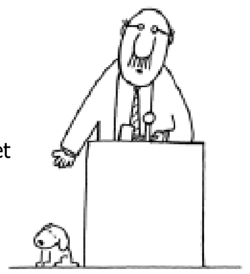
II. DEFINITIONS OF VALUE

Auctions / § 363 Sale of Assets or Entity

While the price is set by the auction process, concepts of fair market value still apply:

- Willing buyer and willing seller
  - Strategic buyer – acquisition value
  - Financial buyer – wants to pay below market in order to earn an above market return – buy low/sell high
- Reasonable knowledge of relevant facts
  - Data room – allows access to information to all qualified bidders
- Valuation used to set "stalking horse"/minimum price



"The bidding will start at eleven million dollars."

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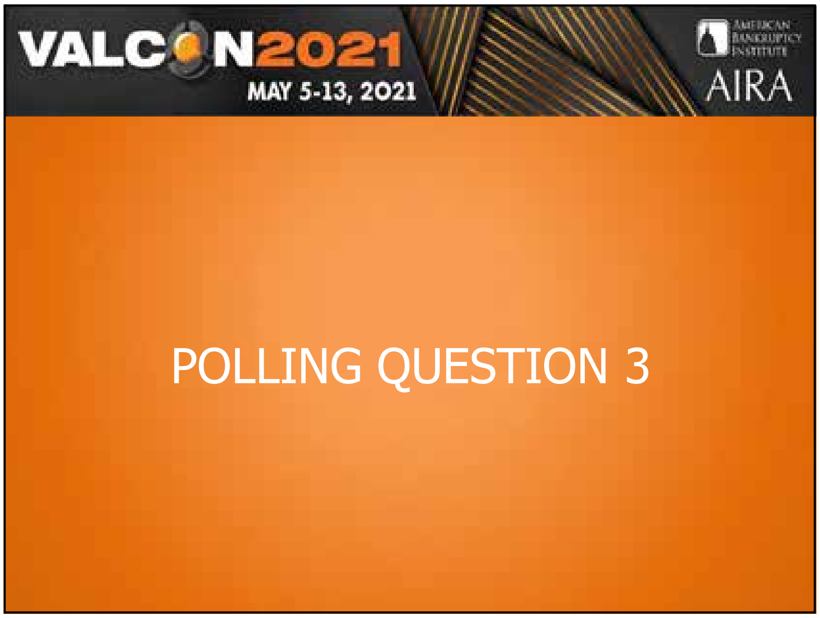
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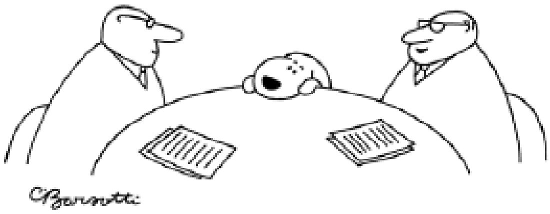
III. STEPS IN THE BUSINESS VALUATION



"I give you the seven-billion-dollar pup, then you give me back the seven-billion-dollar pup, and we've each made seven billion dollars."

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III. STEPS IN THE BUSINESS VALUATION

Steps in the Business Valuation

1. Legal interest
2. Characteristics
3. Valuation date
4. Purpose
5. Standard of Value
6. Premise of Value
7. Approach

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POLLING QUESTION 4

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III. STEPS IN THE BUSINESS VALUATION

Steps 1, 2, and 3

Step 1: Define the legal interest

- Name
- Partnership, Corporation, Other
- Equity versus Enterprise

Step 2: Identify ownership interest characteristics

- Control
- Marketability
- Others

Step 3: Select valuation date

- Limiting conditions
- Use of data relative to this date

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III. STEPS IN THE BUSINESS VALUATION

Step 4 – Define the Purpose

- Examples in a bankruptcy context:
  - Assessing viability of the debtor's operations and the prospects for reorganization
  - Assessing values of business units or other assets to sell to generate liquidity or rationalize the business
  - Advising creditors on the potential value of the distressed assets and settlement value
  - Evaluating asset sale prices and offers
  - Estimating collateral values
  - Setting a "stalking horse" bid in a §363 auction process

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III. STEPS IN THE BUSINESS VALUATION

Step 5 – Identify the Standard of Value

- Fair market value
- Fair value
- Investment value
- Acquisition value
- Intrinsic value

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III. STEPS IN THE BUSINESS VALUATION

Step 6 – Identify Applicable Premise of Value

"an assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation."
– *International Glossary of Business Valuation Terms*

Going Concern

Mass Assemblage of Assets

Liquidation Value

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III. STEPS IN THE BUSINESS VALUATION

Premise of Value – Going Concern

- Will continue operations for a reasonable period of time – *AICPA*
- Company has, for example:
  - trained work force
  - operational plant
  - necessary licenses, systems, and procedures in place
- Income-generating characteristics of all of the tangible and intangible assets as a going concern enterprise

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III. STEPS IN THE BUSINESS VALUATION

Premise of Value – Assemblage of Assets

- Assets are capable of being, but are not currently, part of an income producing business
- Assumes that the assets will be sold in aggregate
- Assets may include certain intangible assets such as patents, trademarks, copyrights, and computer software, but not an assembled workforce, goodwill, or other assets typically associated only with a going-concern

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POLLING QUESTION 5

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III. STEPS IN THE BUSINESS VALUATION

Premise of Value – Liquidation Value

- **Liquidation value**
  - Orderly Liquidation Value ("OLV") - Assets are sold piecemeal with a reasonable amount of time allowed for market exposure
  - Forced Liquidation Value ("FLV") - Assets are sold piecemeal with less than normal market exposure
  - Used in "Best Interests of Creditors Test"

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III. STEPS IN THE BUSINESS VALUATION

Step 7 – Identify Applicable Approaches

Income Approach	• Discounted Cash Flow Method ("DCF") • Direct Capitalization Method
Market Approach	• Comparable Public Company Method • Comparable M&A Method
Asset Approach	• Asset Accumulation Method • Excess Earnings Method

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III. STEPS IN THE BUSINESS VALUATION
Summary
Step 5
Standard
Fair Market Value
Fair Value
Investment Value
Asset Value
Intrinsic Value
Step 6
Premise
Going Concern
Mass Assemblage of Assets
Liquidation Value
Step 7
Approach
Income Approach
Market Approach
Asset Approach
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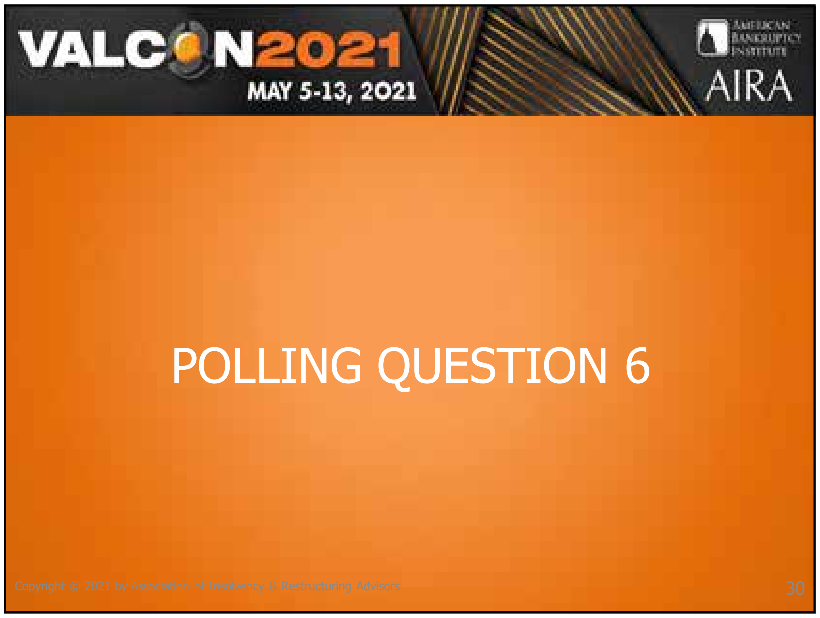
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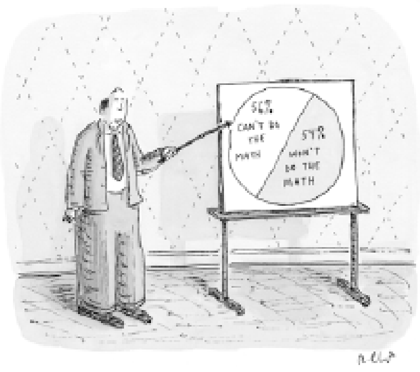
IV. APPROACHES TO VALUATION - *INCOME APPROACH*



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IV. INCOME APPROACH

Approaches to Valuation – Income Approach

- Value of an asset is the present value of the cash flow expected to be generated by the asset
- Value estimated based on:
  - Projected cash flows
  - Weighted Average Cost of Capital (WACC)
- Expected cash flows are:
  - Cash flows during the projection period
  - Terminal value at the end of the projection period based on stabilized cash flow
  - Assets not needed for operations
    - Excess cash
    - Other non-necessary assets

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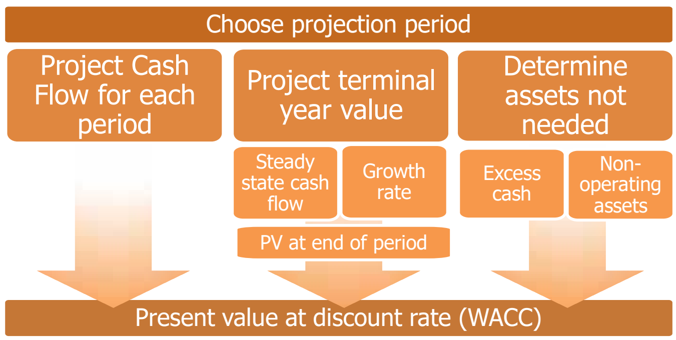
IV. INCOME APPROACH

Steps in DCF Approach



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IV. INCOME APPROACH

Steps in DCF Approach

Calculate WACC

Determine capital structure

Cost of equity | Cost of debt

MCAPM | Long term interest rate | Adjust for tax rate

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IV. INCOME APPROACH

Equity Valuation

Two Options:

- **Indirectly value the equity** by valuing invested capital (Enterprise Valuation) and subtracting the value of interest-bearing debt

  Example:

Value of Enterprise	=	200,000
Value of Debt	=	(150,000)
Value of Equity	=	50,000

  - Must value debt, may need to include pension obligations, etc.
- **Directly Value the Equity**

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IV. INCOME APPROACH

Enterprise Valuation

- Cash Flow to Invested Capital: Represents cash flow available to debt and equity holders

EBIT (1 – tax rate)	
+	Depreciation and other non-cash charges
-	Capital expenditures
+/-	Incremental change in debt-free net working capital ("DFNWC")
=	Cash flows to Invested Capital ("CFIC")
Discount at Weighted Average Cost of Capital (WACC)	

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IV. INCOME APPROACH

Equity Valuation

- Cash Flow Available to Equity:

Net Income	
+	Depreciation and other non-cash charges
-	Capital expenditures
+/-	Incremental change in debt-free net working capital ("DFNWC")
-	Preferred dividends
-	Principal repayments
+	Proceeds from New Debt Issues
=	Cash Flows to Equity ("CFE")
Discount at Cost of Equity	

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IV. INCOME APPROACH

Calculating Terminal Values

Determine steady state cash flow

Determine cost of capital

Calculate value of perpetuity with or without growth

This is the value of at the **end** of the projection period

Calculate Present Value back to the valuation date

Perpetuity method – No growth:

Steady state Free Cash Flow / Cost of Capital

With growth

Steady state Free Cash Flow / (Cost of Capital – Growth rate)

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IV. INCOME APPROACH

Calculating Terminal Values - Multiples

- Multiple is the inverse of the capitalization rate
- Multiples of stable guideline firms can be used to estimate terminal value (discussed in Market Approach)
- CFE or CFIC x comparable companies multiple discounted to the valuation date
- Criticisms
  - Applicability of current multiples to the future
  - Mixes income and market approaches
  - Is the appropriate ownership interest captured in the multiple?

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IV. INCOME APPROACH

Cost of Capital

- Cost of capital is weighted average of cost of debt and cost of equity – "WACC"
- Weights based on expected capital structure upon emergence or transaction date and expected changes during projection period

	Weight	Cost	Weighted Cost
Debt	60%	8%	4.80%
Equity	40%	18%	7.20%
Weighted average cost of capital			12.00%

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IV. INCOME APPROACH

Cost of Debt

- Determine the cost of debt based on the current yield-to-maturity on corporate bonds with a similar maturity and default rating as subject company
- Often a company's cost of debt will be calculated based on its actual capital structure and marginal cost of borrowing under each type of bond or credit facility
- Estimated based on capital structure at valuation date
- Rate should be reduced by tax shield impact
- Cost of debt = Long-term interest rate * (1 – tax rate)

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IV. INCOME APPROACH

Cost of Equity - Overview

CAPM

Risk-free rate | Beta

Un-lever beta

Re-lever beta

MCAPM

Size | Alpha

Control | Marketability

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IV. INCOME APPROACH

Cost of Equity

- Implicit rate of return necessary to attract investor
- Cost of common equity = Risk-free rate + Equity risk premium
- Capital Asset Pricing Model (CAPM) and Modified CAPM (MCAPM)
- CAPM: E(R)=R(f)+ß(ERP)

  E(R)=Expected return on an individual security

  R(f)=Rate of return on risk-free security

  ß=Beta, systemic risk of security in relation to overall market

  ERP=Equity risk premium for the market

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IV. INCOME APPROACH

Risk-free Rate

- Long-term (10-20 year) U.S. Treasury Coupon Bond Yield, 2 to 5%
- Long-horizon expected equity risk premium: large company stock total returns minus long-term government bond income returns +/- 5%
- ERP = Forecast rate of return on the market – Risk free rate

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IV. INCOME APPROACH

Beta

- A measure of a stock's volatility to that of an average stock
- Market measures overall risk – Beta adjusts for systemic risk
- Generally determined by running a linear regression between past returns on the stock and past returns on a market index
  - > 1: Greater systematic risk than overall market
  - = 1: Same systematic risk as the overall market
  - < 1: Less systematic risk than overall market
- Beta for subject company determined through analysis of guideline companies

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POLLING QUESTION 7

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IV. INCOME APPROACH

Unlevered and Relevered Beta

- Reported betas include the risk to a stockholder due to the debt financing of the company
- Guideline betas must therefore be un-levered based on the capital structure of each of the guideline companies
- Unlevered Beta is then re-levered for expected capital structure of the subject company

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IV. INCOME APPROACH

Unlevered and Relevered Beta

Step 1: Compute the unlevered beta (β_u) for each of the guideline companies with the below formula, using the levered beta (β_l), tax rate and the debt-to-equity ratio of each guideline company.

$$\beta_u = \beta_l \;/\; [1 + (1 - \text{tax rate})(\text{Debt/equity*})]$$

Step 2: Select the appropriate unlevered beta to apply to the subject company (e.g., mean, median)

Step 3: Relever the unlevered guideline beta based on the tax rate and debt/equity of the subject company per this formula:

$$\beta_l = \beta_u * [1 + (1 - \text{tax rate})(\text{Debt/equity*})]$$

*Debt and equity at market value, if available

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IV. INCOME APPROACH

CAPM Example

Unlever and relever Beta

Guideline Levered Beta* = 1.4
Guideline Tax Rate = 30%
Guideline Debt / Equity = 50%
Company Tax Rate – 30%
Company Debt / Equity = 67%
Unlevered Beta =
1.4 / (1 + (1 - 0.3)*0.50)) = 1.0
Relevered Beta =
1.0 * (1 – 0.3) * 0.67 = 1.2

CAPM: E(R)=R(f)+ß(ERP)

E(R)=Expected return
R(f)=risk-free rate = 2%
ß=Beta – higher risk = 1.2
ERP=Risk premium = 5%

CAPM: 8% = 2% +(1.2*5%)

*For this purpose, assume there is just one guideline company.

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IV. INCOME APPROACH

Cost of Equity

- MCAPM includes additional adjustment for size effect (RP(s)) and unsystematic risk (company specific risk - Alpha)
- Modified CAPM (MCAPM)

  E(R) = R(f) + ß(ERP) + RP(s) + Alpha

- MCAPM is more applicable to valuation of a privately held company

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POLLING QUESTION 8

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IV. INCOME APPROACH

Cost of Equity – Adjustments

- Cost of equity may be adjusted for:
  - Lack of control (Minority Interest)
  - Where the holders of the interest in the company lack the ability to exercise control, the value of the interests held by the minority shareholder is worth less than the proportionate share of the company's value
- Lack of marketability
  - Discount is generally applied to the value of equity and not cost of capital except in bankruptcy where it is sometimes applied to adjust the cost of capital

IV. INCOME APPROACH

Alpha Risk

- "Alpha" is a measure of unsystematic or company specific risk.
- Risk factors to consider include:
  - Small company (size)
  - Changing technology
  - Key person dependence
  - Regulatory change
  - Key supplier dependence
  - Pending litigation
  - Customer concentration
  - Forecast uncertainty (achievability)

IV. INCOME APPROACH

Modified CAPM - Example

- Modified CAPM (MCAPM)

E(R) = R(f) + ß(ERP) + RP(s) + Alpha

E(R)	=	Expected return on an individual security
R(f)	=	risk-free rate = 2%
ß	=	Beta – higher risk = 1.2
ERP	=	market risk premium = 5%
RP(s)	=	small co risk premium = 5%
Alpha	=	supplier dependence = 3%

MCAPM: 16% = 2% +(1.2*5%) +5% +3%

IV. INCOME APPROACH

Income Approach – Common Errors

- The discount rate is not consistent with the cash flow stream
- The discount rate is not consistent with the implied capital structure
- Growth assumptions are inconsistent with other model assumptions
- The terminal year value discounted at an incorrect number of periods
- Assumptions imply a different standard or premise of value than defined

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V. APPROACHES TO VALUATION - *MARKET APPROACH*

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V. MARKET APPROACH

Market Approach

- Theoretical basis: principle of substitution – a prudent buyer will pay no more for a property than it would cost to acquire substitute property with the same utility
- Based on market values of comparable assets
  - Guideline Public Company Method
  - Guideline Merger & Acquisition Method (Similar Transactions Method)
  - Historical Internal Transactions Method
- Multiples can be calculated on an equity or invested capital basis

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V. MARKET APPROACH

Guideline Public Company Method - Overview

- Select guideline publicly traded companies
- Adjust peer group and subject co. financial statements for comparability; calculate value measurement (MVIC or equity)
- Assess subject company's performance and prospects vis-à-vis peer group; apply appropriate multiples to fundamentals of the subject company
- Standard of value produced - Fair market value
- Relative level of value produced - Marketable minority interest
- Premise of value - Going concern

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V. MARKET APPROACH

Steps in Applying Market Approach

1. Identify and select guideline companies
2. Normalize financial statements
3. Perform comparative financial analysis
4. Calculate guideline company multiples
5. Select and calculate applicable parameter(s) for subject company
6. Select and apply multiple(s) to subject company parameter(s)
7. Adjust for any other factors
8. Adjust for ownership characteristics
9. Add value of any non-operating assets

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POLLING QUESTION 10

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Guideline Companies		Enterprise Value (in $millions)			EBITDA					
Company Name	**Symbol**	**Net Debt**	**Mkt Cap**	**EV**	**Sales**	**Op. Mgn.**	**Op Inc.**	**Dep.**	**EBITDA**	**EBITDAx**
Black Shoe Co.	BSC	199.1	1,218.9	1,418.0	2,680	7.3%	195.6	55.0	250.6	5.7
Some Shoe, Inc.	SSI	14.4	1,074.3	1,088.7	1,180	11.0%	129.8	42.0	171.8	6.3
Outdoor Footware	OFW	154.6	3,138.8	3,293.4	2,020	17.8%	359.6	83.0	442.6	7.4
Worker Boots Co	WWW	1,096.6	2,687.5	3,784.1	2,820	12.0%	338.4	54.0	392.4	9.6
Sneakers U.S.A., Inc.	SNUSA	119.5	2,787.8	2,907.3	2,730	11.0%	300.3	-	300.3	9.7
Slipper, Inc. 'B'	SI-B	1,347.0	78,087.1	79,434.1	30,650	15.5%	4,750.8	530.0	5,280.8	15.0
SM, LTD	SHW	-	1,924.0	1,924.0	1,530	18.0%	275.4	15.0	290.4	6.6
Giant Inc.	GIF	76.4	1,796.4	1,872.8	3,025	10.5%	317.6	80.0	397.6	4.7
Mean		376.0	11,589.3	11,965.3	5,829.4	0.1	833.4	107.4	940.8	8.1
Median		137.1	2,305.7	2,415.6	2,705.0	0.1	309.0	54.5	346.4	7.0
Use										7.0
Grant Shoe - EBITDA Multiple 2020							14	1.5	15.5	
Estimated Enterprise Value (no multiple adjustment)										108.5
Adjusted multiple 70% (small company, etc.)										4.9
Estimated Enterprise Value small company adjustment										76.0
Additional Adjustments										
NOL 2020 (=14.0*.4)									5.6	4.7
NOL 2021 (=16.0*.4)									6.4	4.4
Asset Sales										1.0
Estimated Enterprise Value including all adjustments										86.1

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POLLING QUESTION 11

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V. MARKET APPROACH

Merger and Acquisition Method

General overview of the method

- Identify and select guideline merged or acquired companies
  - 8-K documents filed by public companies
  - Various private company information databases, including Mergerstat, Pratt's Stats, IBA Database, M&A magazine, etc.
- Identify and select guideline transactions
  - SIC code, product line, financial size
- Analyze target company historical financial information
  - Availability of data
  - Similarity to public company data

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V. MARKET APPROACH

Merger and Acquisition Method, *continued*

- Calculate earnings fundamentals of the target company
  - Often may be limited to LTM data
- Calculate transaction price and associated terms
- Calculate target company transaction multiples
- Apply transaction multiple to subject company
- Standard of value produced - Fair market value vs. investment or strategic value
- Relative level of value produced - Controlling interest, Marketable vs. non-marketable, disagreement
- Premise of value - Going concern vs. liquidation

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V. MARKET APPROACH

Common Errors

- Incomplete adjustments
- Mismatching numerator with denominator
- Mismatching time periods
- Mismatched definitions of variables
- Calculation of biased multiples

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VI. APPROACHES TO VALUATION - *Asset approach*

"My problem is that I invested in liabilities that I thought were assets."

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VI. ASSET APPROACH

Asset Approach

- Two General Methodologies
  - Asset Accumulation or Net Asset Value
  - Excess Earnings Method
- Most useful in following conditions:
  - Subject company holds significant tangible assets
  - Companies in manufacturing or distribution businesses
  - Businesses which are non-labor-intensive
  - Companies with no significant intangible assets
  - Companies with no established earnings history

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POLLING QUESTION 12

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VI. ASSET APPROACH

Asset Accumulation or NAV Methodology

1. Balance sheet as of, or as near, to the valuation date
2. Adjust for known missing assets or liabilities and update to reflect values as of the valuation date.
3. Adjust each tangible asset and identifiable intangible asset to appraised value, based on the appropriate standard and premise of value.
4. Adjust liabilities to their appraised or market values, if different from their book values.
5. Make necessary adjustments for income taxes and interest-bearing liabilities.

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VI. ASSET APPROACH

Methodology, *continued*

6. Subtract the value of the liabilities from the value of the assets to derive the value of total equity. Adjust for preferred stock or other senior equity securities to determine the value of the common equity
7. Perform "sanity checks" to determine the reasonableness of the values computed
8. Determine if the values computed should be adjusted for applicable discounts.

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VI. ASSET APPROACH

Problems with Asset Accumulation Method

- Intensive and requires integration of numerous valuation concepts and methodologies
- Consistency within the valuation assumptions across asset classes may be lacking
- Fails to account for unidentifiable intangible assets and goodwill
- Generally, will understate the value of a going concern
- Excess Earnings Method attempts to bridge this gap

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Q and A

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