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Valuation Challenges in the Current Environment

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Case Study: Quorum Health Corp.



Quorum Health Corp.

- Quorum Health Corporation (“Quorum” or the “Company”) was spun-off from Community Health Systems (“CHS”) in April 2016 as an independent public company with a portfolio of 38 hospitals and outpatient centers located in rural and mid-sized markets across 13 states.
- Rural and mid-sized healthcare providers like Quorum have capped revenue prospects given (i) the number of possible patients that live in a particular service area and (ii) often render services at reduced rates through Medicare, Medicaid and other government programs.
- Medicare and Medicaid made up 49% of the Quorum's net revenue for the year ended December 31, 2019.
- The 2016 spin off from CHS saddled Quorum with a debt load in excess of \$1.3 billion that it ultimately could not support.



Quorum Health Corp.

- Following its spinoff from CHS, Quorum shut down certain facilities and started selling assets.
- Quorum experienced a decrease in sales growth year-over-year following the 2016 spin-off, with overall revenue of \$2.072 billion (2017) and \$1.879 billion (2018).
- Quorum revised its 2019 revenue and adjusted EBITDA guidance reflecting expectations of continued performance deterioration and slower-than-expected cost-savings.
- By late 2019, Quorum and its creditors were in workout negotiations. Quorum's negotiating objective was as follows: a prepackaged Chapter 11 filing, with bondholders agreeing to support an equitization plan and a new capital raise (paying down secured debt on the plan's effective date) through a rights offering.
- And then COVID happened...



Quorum Health Corp.

- The CARES Act was enacted on March 27, 2020, allocating \$100 billion to HHS for a Provider Relief Fund, with an additional \$75 billion appropriated for the Provider Relief Fund through the Paycheck Protection Program and Health Care Enhancement Act. During the pendency of its chapter 11 cases, Quorum received more than \$100 million in CARES Act funding.
- On April 7, 2020, Quorum filed for chapter 11 protection, with an RSA in hand signed by 74.7% of its secured lenders and 97.3% of its bondholders.
- Quorum's RSA and prepackaged plan provided for (i) a debt-to-equity swap of \$400M of its senior notes; (ii) an equity commitment of at least \$200 million; (iii) a \$785M take-back first lien term facility to refinance the revolving credit facility (\$47M) and the term loan facility (\$738M) subject to a \$50-100M paydown; and (iv) payment in full of all general unsecured claims, which included trade claims, physician claims, and patient claims.



Quorum Health Corp.

- Advancing to confirmation, Quorum contended its valuation was between \$965 million and \$1.275 billion, based on utilization of three primary valuation methodologies (DCF, comparable companies, and precedent transactions).
- A large equityholder challenged this valuation, contending that it failed to fully factor in CARES Act proceeds and NOLs. This equityholder proposed a valuation between \$1.64 billion and \$1.86 billion.
- The equityholder also argued that the Debtors' receipt of approximately \$100 million in CARES Act funds was an "injection of additional capital" that the Debtors could use for any purpose, including distributions to equityholders. The Debtors disagreed, based on HHS' guidance that CARES Act funds could only be used for COVID-related expenses and losses.
- Following a five-day confirmation trial, the Court overruled the equityholder's objections and interpretation of the CARES Act, and confirmed the Debtors' prepackaged plan on June 30, 2020.



Quorum Health Corp.

- The Court accepted Quorum's accounting methodology for the receipt and use of CARES Act funds given the risks related to the improper use of those funds, anticipated audits, and potential future recoupment by HHS.
- The Court also held that it was an ordinary and prudent business practice for Quorum to modify its financial projections during the pendency of the case in light of COVID and the continuing revenue cycle management difficulties plaguing the Company
- The Court specifically found Quorum's use of a 10.9% size premium under a DCF approach reflective of the industry's high operational leverage. The Court noted that there were no other viable transactions to consider under the Debtors' precedent transactions approach.
- The Court concluded that Quorum's plan was the only value-maximizing transaction and the best and only actual proposal available to the Debtors – stating that "reasonable minds can disagree" on valuation.



How Do We Assess Business Worth
In Such Unusual Times?



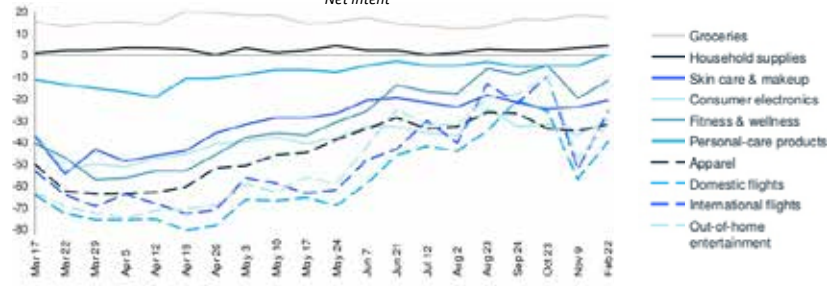
“Strange days have found us
Strange days have tracked us down
They're going to destroy
Our casual joys
We shall go on playing or find a new town”

Strange Days
By The Doors



COVID-19 dramatically changed consumer buying patterns, across all sorts of industries. The speed and extent of change renders, in many industry segments, prediction of future patterns akin to fortune telling.

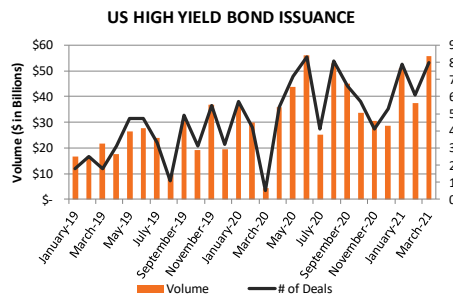
Expected Spending per Category Over Next Two Weeks Compared to Usual, March 2020 - March 2021
Net intent⁽¹⁾



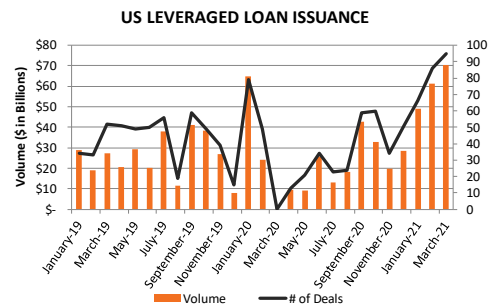
(1) % of respondents expecting to increase spending minus % of respondents expecting to decrease spending
Source: McKinsey



Markets were also disrupted. In one year, ice-cold capital markets have become red hot, due to government stimulus and profit expectations stemming from a year's worth of "pent-up" demand...



Source: S&P Global Market Intelligence



Source: S&P Global Market Intelligence



Sample Points Of Input-Data Uncertainty

- COVID-related Customer Volatility
- One-Time Government Infusion
- Ebbs and Flows of Non-Government Liquidity Availability
- Ebbs and Flows of M&A Interest
- Facility Restart/Relocation Costs
- Customer/Vendor Restart Costs (Including Delay Costs)
- Logistics Dislocation/Costs
- Other Operating Stagnancy/Inefficiencies
- New Executive/Employee Costs



Bankruptcy Valuation Methodologies Are Not Well-Equipped

- Discounted Cash Flow Analysis: Anticipated Cash Flows
 - Reliant on management projections, but how does one “project” in this environment?
 - Requires “normalizing” EBITDA, but how do you “normalize” out of a pandemic? *Cox Enterprises v. News-Journal Corp.*, 510 F.3d 1350, 1358–59 (11th Cir. 2007) (court “normalized” margins to enable a valuation comparison with other companies); *Chartwell Litig. Trust v. Addus Healthcare, Inc. (In re Med Diversified, Inc.)*, 346 B.R. 621, 629–30 (Bankr. E.D.N.Y. 2006) (referencing “normalized” EBITDA to enable a more accurate valuation); *In re Emerge Energy Services LP*, 19-11563 (KBO), 2019 WL 7634308, at *9 (Bankr. D. Del. Dec. 5, 2019) (“While certainly normalization is appropriate when extraordinary and nonrecurring events occur so that the subject and comparable companies can be more accurately compared, the literature relied upon by the parties suggests that doing so requires an expert to normalize based on managements’ expectation of operations, primarily using historical data.”)





Bankruptcy Valuation Methodologies Are Not Well-Equipped

- Discounted Cash Flow Analysis: Weighted-Average Cost of Capital.
 - How does one think about “beta” when the market generally and the debtor specifically is mercurial? See Richard A. Booth, “Calculating Beta,” *Financing the Corporation* § 2:28 (December 2020 Update) (“The beta of a publicly traded stock is a measure of that stock’s **observed** volatility. Thus, beta as calculated on the basis of changes in market price reflects the risk inherent in the subject stock, taking into consideration all relevant factors, including leverage. In other words, observed beta is inherently leveraged.”)(emphasis in original). See also *DFC Glob. Corp. v. Muirfield Value Partners, L.P.*, 172 A.3d 346, 385 (Del. 2017) (“Beta measures expected market risk. It represents the covariance between the rate of return on a company’s stock and the overall market return.”) (citing Shannon P. Pratt & Roger J. Grabowski, *Cost Of Capital* 271 (5th ed. 2014)).
 - Is there room for any discussion over “company specific risk premium” in this economic environment? See Stan Bernstein, Susan H. Seabury and Jack F. Williams, “Squaring Bankruptcy Valuation Practice With Daubert Demands,” 16 Am. Bankr. Inst. L. Rev. 161, 193 (“Delaware courts have recognized the problems in relying on adjusted historical betas as a way by which an expert may capture unsystematic risk . . . assigning a company-specific risk premium, for example, to a discount rate used in a business valuation may dramatically impact value and may be problematic in light of weak empirical proof and the reliability of measure.”) See also *Delaware Open MRI Radiology Associates, P.A. v. Kessler*, 898 A.2d 290, 338 (Del. Ch. 2006) (rejecting the concept of implementing artificially discounted values and stating, “not all public companies have a sufficient public float for trading in their shares to provide a reliable beta for use in calculating their cost of capital, forcing a resort to the use of data from the industry or so-called comparable companies.”)



Hypothetical Case Study: Olfax, Inc.



Olfax, Inc.

- Olfax is a life-sciences start-up founded in 2017, based at MIT, that is developing a treatment for olfactory nerve damage due to injury.
- The company is the brainchild of Dr. Oleg Factotum, a brilliant but eccentric scientist affiliated with the university. He regularly refers to Olfax as his “only child” that “gives his life meaning.”
- Olfax raised \$150 million in PE equity capital, and \$150 million in debt finance (\$50 million owed to the PE-sponsor as secured debt) and \$100 million in unsecured bonds (maturing this June).
- Olfax holds patents for a surgically-inserted device (the “Olfactorator”), as well as a drug (“Olfadryx”) to aid in olfactory nerve stimulation. The Olfactorator is in the testing stage, and Olfadryx is still in the research stage. Early tests have been promising, but FDA approval has not yet been sought for either.
- Olfax also holds a patent on a neurostimulation process, the licensing fees for which bring in about \$15 million/year. This is sufficient to maintain basic operations, with a few million left for incremental expenses.



Olfax, Inc.

- There is enormous market potential, if the Olfactorator or Olfadryx is effective in restoring smell and taste loss due to COVID. Research is incomplete, and expenses are set to outpace available funding. But, a recent non-binding indication of interest suggests TEV of at least \$75 million.
- Given the upcoming maturity, the debtor is considering exploration of the capital and M&A markets, but time is tight. Moreover, Olfax is small, new, and niche – it may not yet be attractive to any market.
- The bonds are located in a few small hedge funds that do not, today, seem to have financial capacity to (i) refinance the secured debt and (ii) supply sufficient capital to fully test the debtor’s technology. But, there are decent prospects of future investment from government units or, as financiers are finding fewer and fewer opportunities, private investment capital.





Strategic Options

- Expose the company to the capital and M&A markets, if the bonds will forbear.
- Allow the secured lender (PE sponsor) to retake the company via Section 363 credit bid, subject to higher or better offers.
- “Free fall” bankruptcy, enabling more data collection and markets to settle.



In re Olfax, Inc.



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Debtors' Counsel



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Advisor to Bank Lenders



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Christopher J. Kearns
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Questions?

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Jefferies



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Faculty

Christopher J. Kearns, CPA, CFA, CTP, CIRA is co-head of Berkeley Research Group, LLC's Corporate Finance practice in New York, where he specializes in financial restructuring advisory services, crisis management and expert testimony in the troubled-company and corporate finance environment. He has represented parties in interest in numerous complex, multinational matters and has served as CEO, CRO, responsible officer, receiver and trustee. Mr. Kearns has rendered expert testimony in multiple jurisdictions on matters involving valuation, lost profits, solvency, credit analysis, liquidation and recovery analysis, and other issues in distressed situations. He also has advised major investment banks and potential purchasers on acquisition strategies and post-merger integration. Before co-founding Capstone Advisory Group, LLC, Mr. Kearns was a senior managing director at the Policano & Manzo legacy practice of FTI Consulting and was also with the predecessor firm Kahn Consulting. Previously, he spent three years with Bristol-Myers Squibb in assignments that included assistant corporate controller. He also spent 10 years in the mergers and acquisitions group and the audit practice of a major international public accounting firm. Mr. Kearns is a member of AICPA, the New York State Society of CPAs and the Association of Insolvency and Restructuring Advisors. He served as president of the New York chapter of the Turnaround Management Association. Mr. Kearns received his B.B.A. in accounting from Iona College.

Michael O'Hara is co-head of the U.S. and a managing director in the Debt Advisory and Restructuring Group of Jefferies LLC in New York. He provides investment banking advisory services on a variety of restructuring and special-situation assignments for companies, creditors, corporate board committees, and acquirers and sellers of distressed assets. Mr. O'Hara's notable company/debtor assignments include AbitibiBowater, Akorn Pharmaceuticals, American Axle & Manufacturing, AIG, Ascent Resources Marcellus, Brock Group, Energy Future Holdings, EXCO Resources, Fusion Connect, Mallinckrodt, MoneyGram, Mrs. Fields, Quad Graphics (re: Vertis), RockPile Energy Services, Samson Resources, Southland Royalty Co., Taro Pharmaceutical, Travelport, Triangle Petroleum and Washington Mutual, among others. His creditor assignments have included Chaparral Energy, Dana, Delphi, Eastman Kodak, EP Energy, Extraction, Gulfport, Hostess Brands, Intrawest, Jupiter Resources, Lehman, Preferred Sands, Quicksilver Resources, Ultra Petroleum and Vanguard Natural Resources, among others. Mr. O'Hara has worked on several sovereign situations, including Argentina (Enron/Azurix), Greece and Iceland (Kaupthing). He has served as a guest lecturer at the University of Chicago Booth School, Columbia Business School and the Wharton School at the University of Pennsylvania, among others, and has participated in many restructuring industry conferences. Before joining Jefferies, Mr. O'Hara was a partner in the Restructuring and Special Situations Group of PJT Partners (formerly Blackstone). He also previously worked in the M&A groups at Wasserstein Perella & Co. and Stephens Inc. Mr. O'Hara received his B.S. in finance from Georgetown University and his M.B.A. from Columbia Business School.

Felicia Gerber Perlman is a partner in the Chicago office of McDermott Will & Emery, where she focuses her practice on complex business reorganizations, debt restructurings and insolvency matters. She also is the global co-head of the firm's Restructuring and Insolvency Practice Group. Ms. Perlman advises debtors, creditors, lenders, investors, sellers, purchasers and other parties-in-interest in all stages of restructuring transactions, from chapter 11 reorganizations to out-of-court negotiations,

workouts and acquisitions. She frequently presents on bankruptcy topics and is featured in several notable publications. Ms. Perlman is a frequent speaker and has been recognized in *Turnarounds & Workouts* as one of the nation's "Outstanding Young Bankruptcy Lawyers," and she has repeatedly has been selected for inclusion in *Chambers USA: America's Leading Lawyers* for Business and *The Best Lawyers in America*. In addition, she received the 2017 Flex Success Award from The Diversity & Flexibility Alliance for her commitment and success in creating and working in a flexible environment. She also was named by *Crain's Custom Media* as one of Chicago's Notable Women Lawyers in 2018. Ms. Perlman has been a member of the boards of directors of the Women in Law Empowerment Forum and the Chicago Coalition of Women's Initiatives in Law Firms, and she is a Fellow in the American College of Bankruptcy. She received her B.A. and B.S.E. in 1989 from the University of Pennsylvania's Wharton Business School, and her J.D. in 1992 from Northwestern University Pritzker School of Law.

Ben Pickering is a principal in Ernst & Young's Restructuring Advisory Services group in New York and leads its U.S. Restructuring Life Sciences team. He has 30 years of professional experience addressing special situations and distressed matters for a wide variety of constituents. Mr. Pickering has in-court and out-of-court experience addressing such issues as business planning, alternatives and execution, strategic alternatives, enterprise restructuring, recovery alternatives and analysis, negotiation and resolution with various stakeholders, liquidity analysis and financial constraints resolution, cash flow and financial modeling under steady state and alternative operating scenarios, and financial reporting and monitoring. Immediately prior to joining EY, Mr. Pickering served as the interim CFO of a distressed pharmaceutical company. In this role, he led the negotiations with its sponsor and lenders, as well as other key stakeholders. He also reorganized the accounting and treasury functions, and implemented cash-flow and financial forecasting for use in business planning and negotiations with key stakeholders and restructured operations. He also prepared and negotiated the potential financing options required to support the company, and led the preparations for a potential chapter 11 filing and, ultimately, the sale of the business via a creative mechanism. In addition, Mr. Pickering has also advised clients on crisis resolution and rapid cost takeout, operational alternatives and related impacts, including strategic assessment and options analysis, the restructuring of operations, divisional consolidation/rationalization, business divestitures and debt restructuring. His international experience includes matters in the U.S. and Canada, Trinidad, the Cayman Islands, Bermuda, the U.K., Cyprus, Greece, Ivory Coast, Liberia, China (including Hong Kong and Macau before the handovers) and Thailand. Mr. Pickering received his B.A. in commerce from the University of Toronto.

Robert J. Stark is a partner with Brown Rudnick LLP in New York and the practice group leader for the firm's Bankruptcy & Corporate Restructuring Practice Group in the U.S. He focuses his practice on complex corporate restructuring, including in-court chapter 11 cases and out-of-court workouts. He also has extensive experience representing debtors/borrowers, secured and unsecured creditors, official creditor/equity committees, and other significant parties-in-interest in large corporate insolvency matters. Mr. Stark's case experience includes the representation of an official or significant adhoc creditor/equity committee in the restructuring of American Safety Razor, CEDC, Colt Defense, Delta Petroleum, The Dolan Co., Endeavour International, Energy Conversion Devices, Evergreen International Aviation, Falcon Products, Fedders, Flying J/Big West Oil, Forest Oil, Green Field Energy Services, Green Valley Ranch Hotel and Casino, Hawkeye Renewables, Hayes Lemmerz International, InSight Health Services, Le-Nature's, Lionel Trains, *Minneapolis Star Tribune*, Motor Coach Industries, Newark Group, NV Broadcasting, Oakwood Homes Corp., Oneida, Owens Corn-

ing, Patriot Coal, Refco Capital Markets, Renewable Biofuels, Riverstone Networks, School Specialty, Spansion, Synagro Technologies, TOUSA, Tropicana Entertainment, Visteon, Washington Mutual and York Research. His debtor/borrower engagements include Keys Resort Investors and Wells Dairy (Blue Bunny Ice Cream), the principal owner of Centrix Financial, and the special committee of the board of directors of Allied Systems Holdings. Mr. Stark has been cited in *The Best Lawyers in America*, *Benchmark Litigation*, *Chambers Global*, *Chambers USA*, *Global M&A Network: Top 100 Restructuring Professionals*, *Legal 500*, *Litigation Counsel of America* (Fellow), *Super Lawyers* and *PLC Which Lawyer*, among others. He has published extensively on bankruptcy and restructuring topics, and was the lead editor of the 400-page legal treatise *Contested Valuation in Corporate Bankruptcy* (Matthew Bender 2011), part of the *Collier on Bankruptcy* monograph series. Mr. Stark is admitted to the Bars of New York and New Jersey, the U.S. District Courts for the Southern and Eastern Districts of New York, the District of New Jersey and the Eastern District of Michigan, and the U.S. Court of Appeals for the Third Circuit. He received his B.A. in 1992 from Lafayette College and his J.D. in 1995 from Vanderbilt University Law School.