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EMERGE-ing Comparable Companies Valuation Analysis

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Valuation is at the heart of every chapter 11 case, yet courts regularly observe that it "is much like a guess compounded by an estimate."[2] One court noted, "Regardless of the method used, the result will rarely, if ever, be without doubt or variation."[3] Most financial valuation models are driven by subjective inputs,[4] and on top of that, companies "could — quite legally — cause net income in any given period to be almost any number" regardless of how the business is doing.[5]

Because valuing companies and their assets is such an amorphous task, it is critical that restructuring professionals fully understand the common valuation methodologies and how they can be manipulated.[6] Grasping the basics of the commonly used valuation methodologies will allow for a greater understanding of the leverage and pressure points in a case.

For example, a recent contested confirmation trial in Delaware centered on a battle of valuation experts where the bankruptcy court made two significant rulings with respect to each parties' valuation that swayed the company's midpoint total enterprise value (TEV) by $122 million.[7] This article focuses on the comparable companies valuation methodology and analyzes the rulings in *Emerge Energy* as they relate to that valuation methodology.[8]

Comparable Companies Basics

When the goal of the valuation is to determine TEV (the value of the total company, including debt and equity), the easiest approach to valuing a company is to determine the current market price that could be garnered through a going-concern sale.[9] However, not all companies will conduct a marketing process for their assets, and courts have stated that none is required.[10] In the absence of a marketing process, valuation experts look to the three standard[11] valuation methodologies: (1) discounted cash flow (DCF); (2) comparable companies; and (3) precedent transactions.[12] Typically, all three are utilized (or an explanation is provided as to why one is not used),[13] and each is assigned a subjective weighting that can be reasonably justified based on the facts and circumstances of the case. A range of value is then determined based on each method's determined value and its relative weighting.

The comparable companies valuation method seeks to derive the value of the subject company by estimating the value of comparable companies. According to the court, "Values are standardized using one or more common variables such as revenue, earnings, or cash flow, with the expert then applying a multiple of the financial metric or metrics that yields the market's valuation of these companies."[14] The key to this analysis is the choice of appropriate comparable companies, which is a subjective endeavor.[15] This method is used more frequently when dealing with private companies where the value of equity is not easily determinable since there is no market.[16] Moreover, under certain circumstances, courts have noted that this method might be more meaningful than DCF or precedent transactions because it is "less susceptible to uncertainties in projections (in the case of DCF) or extraneous factors such as control premiums, synergies or bidding wars (in the case of Precedent Transactions)."[17]

Comparable companies are chosen based on certain criteria, including industry classification, reve-

1 The opinions expressed herein are personal to the author and are not necessarily those of Potter Anderson & Corroon LLP or its clients.

2 7 *Collier on Bankruptcy* ¶ 1129.05[3][c] (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2011) (quotation omitted). *See, e.g., In re Genco Shipping & Trading Ltd.*, 513 B.R. 233, 242 (Bankr. S.D.N.Y. 2014) (stating that valuation is not an exact science); *In re Coram Healthcare Corp.*, 315 B.R. 321, 339 (Bankr. D. Del. 2004) (stating that reasonable minds often disagree on valuation issues).

3 *In re PTL Holdings LLC*, 2011 WL 5509031, at *6 (Bankr. D. Del. Nov. 10, 2011).

4 *Coram*, 315 B.R. at 339 (quotation omitted).

5 Letter from Warren Buffet to the shareholders of Berkshire Hathaway Inc., at 20 (February 2011), *available at* https://www.berkshirehathaway.com/letters/2010ltr.pdf (unless otherwise specified, all links in this article were last visited on Feb. 24, 2020).

6 *In re Nellson Nutraceutical Inc.*, No. 06-10072 (CSS), 2007 WL 201134, at *19 (Bankr. D. Del. Jan. 18, 2007) (holding that management utilized its control over debtor "to manipulate both the business planning and valuation processes to come up with an artificially inflated enterprise value"). As many courts have noted, hired valuation experts often approach their valuation task from an advocate's point of view. *See, e.g., In re Tribune Co.*, 464 B.R. 126, 150 (Bankr. D. Del. 2011); *see also In re Exide Techs.*, 303 B.R. 48, 61 (Bankr. D. Del. 2003) (noting "each side's incentive to either overvalue or undervalue the Debtor").

7 *In re Emerge Energy Servs. LP*, No. 19-11563 (KBO), 2019 WL 7634308, at *7 (Bankr. D. Del. Dec. 5, 2019).

8 The author's firm was co-counsel to the committee in *Emerge Energy*.

9 *See, e.g., Emerge*, 2019 WL 7634308, at *5 (noting that sale process would have made confirmation simpler).

10 *Id.*

11 While there are several other valuation methodologies, if using an alternative valuation method, the proponent should explain to the court why the proposed methodology is appropriate, as the court might be inherently suspicious. *See* Hon. Christopher S. Sontchi, "Valuation Methodologies: A Judge's View," 20 *ABI L. Rev.* 1, 16 (Spring 2012)," *available at* abi.org/member-resources/law-review.

12 For a comprehensive primer on the most common valuation methodologies, *see generally id.*

13 *See, e.g., In re Mirant Corp.*, 334 B.R. 800, 816 (Bankr. N.D. Tex. 2005) (describing experts' reasoning for excluding certain methodologies from valuation analysis).

14 *In re Chemtura Corp.*, 439 B.R. 561, 575-76 (Bankr. S.D.N.Y. 2010).

15 *See, e.g.,* Sontchi, *supra* n.11 (noting that "no two firms are exactly alike in terms of risk and growth, [therefore] the definition of comparable firms is a subjective one"); *Exide*, 303 B.R. at 61 (noting that selecting comparable companies requires subjective assessment).

16 *Cf. Exide*, 303 B.R. at 64, n.32.

17 *Chemtura*, 439 B.R. at 583.

nue,[18] earnings before interest, taxes, depreciation and amortization (EBITDA), diversification and geography,[19] among others.[20] Courts should consider all facts before making a determination regarding whether a company is comparable to a debtor.[21] Once the appropriate comparable companies are chosen, the average multiple is calculated. Some commonly used multiples include TEV/EBITDA, price-to-earnings ratio and TEV/revenue, then the multiple is applied to the company's EBITDA to determine value. Courts typically use the company's EBITDA for the trailing 12 months if and when the company's projections are current, which does not reach so far into the future as to detract from its reliability and can also serve as a test of the accuracy of valuations based on projections.[22]

However, there are a few risks associated with this analysis. If an entire industry is over- or undervalued, the valuation will not be accurate. In addition, it might be easy to manipulate multiples based on accounting policies and the comparable companies themselves.[23]

Comparable Companies Analysis in *Emerge*

In a recent contested confirmation trial, valuation was at the forefront of a dispute between Emerge Energy Services LP and its affiliated debtors (collectively, "Emerge") and the official committee of unsecured creditors.[24] Emerge was in the business of mining, processing and distributing silica sand proppant, a key component in the hydraulic fracking of oil and gas wells.[25] Emerge operated and had facilities in Wisconsin (for northern white sand) and Texas (for in-basin sand), along with a partially developed facility in Oklahoma. Prior to Emerge's bankruptcy filing, the industry moved away from northern white sand and to in-basin production, forcing Emerge to scale back and right-size operations in Wisconsin. In addition, its Texas facility failed to achieve capacity production and further experienced severe damage to its mine, which prevented part of its operations from continuing. In general, the fracking sand industry was volatile leading up to the bankruptcy filing. Prior to the filing, Emerge and its secured lenders entered into a restructuring-support agreement (RSA) that provided for a debt-for-equity swap, with unsecured creditors receiving 5 percent of Emerge's equity if they voted in favor of the reorganization plan. Emerge then filed voluntary petitions to effectuate the RSA through a reorganization plan. However, the unsecured creditors voted to reject the plan, and therefore were set to receive no distribution under the plan if approved.

The committee of unsecured creditors objected to the plan on two primary grounds related to value. First, the plan was not fair and equitable under § 1129(b)(1) of the Bankruptcy Code because secured noteholders were receiving more than they were entitled to receive. Second, the plan violated the best-interests test of § 1129(a)(7) because there were unencumbered assets and value that would flow to unsecured creditors in a hypothetical liquidation. In order for the committee of unsecured creditors to succeed on its value-related arguments, the debtors' TEV needed to exceed the secured-debt hurdle of approximately $317 million.[26]

Using the same business plan and related financial projections and the same two valuation methodologies (DCF and comparable companies) with similar weightings, the debtors' and unsecured creditors' committee's valuation experts arrived at starkly different valuations. The debtors' valuation expert determined the debtors' TEV range to be $180 million and $220 million, with a midpoint of $200 million, while the unsecured creditors' committee's valuation expert determined the TEV range to be $335 million and $445 million, with a midpoint of $390 million.[27] The bankruptcy court addressed certain disputes regarding the experts' DCF and comparable companies analyses that significantly affected their TEV conclusions, including the appropriate set of comparable companies and the use of market value of debt as opposed to book value to calculate the range of EBITDA multiples of the comparable companies.[28]

The experts disagreed on the correct comparable companies to use for determining Emerge's value. Emerge's expert considered five companies but excluded two of them primarily due to their diversification of business lines and size. Emerge noted that both excluded companies had greater sales and scope of operations. The committee's expert included all five companies considered by Emerge's expert because they all "share similar product categories, markets and customers served, and other operating and financial characteristics of the Debtors."[29]

The unsecured creditors' committee noted that the companies were all considered "competitors" of the debtors and that third-party analysts considered them to be comparable companies.[30] However, the bankruptcy court agreed with Emerge, finding that competitors and comparables are "two completely different animals."[31] The court further found that the two excluded companies had considerably more capacity, significantly more facilities, higher reported revenues and more diversification into other business lines than Emerge. These facts convinced the court that "they would cause misleading results if included in the set of comparables."[32] While "there is no perfect comparable set," any effect of having a small sample size of comparable companies could have been offset by discounting the weighting given to the comparable companies valuation.[33] The court found that the result of

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18 *Id.* at 584 (excluding two companies from comp set because their revenues "dwarf" debtors' revenue and therefore are not as risky).

19 *See, e.g., PTL Holdings LLC*, 2011 WL 5509031, at *9 (arguing that certain companies should be excluded because they do no business in the U.S.); *cf. Chemtura*, 439 B.R. at 584 (including foreign companies in comparable companies set because, among other things, they are subject to similar tax and regulatory environments as debtors and half of debtors' revenue comes from outside U.S.).

20 *See, e.g., PTL Holdings LLC*, 2011 WL 5509031, at *9 (holding that company was not comparable because its business segments differed materially from that of debtors and its trading multiples were higher than other comparable companies); *Genco Shipping*, 513 B.R. at 250 (holding that company should be excluded from comparable companies analysis due to corporate-governance issues); *Mirant*, 334 B.R. at 837 (disqualifying comparable company because of differences from debtors' business and its relatively weak financial condition).

21 *Genco Shipping*, 513 B.R. at 250 (holding that size alone would be of less significance in selecting comparable companies in dry bulk shipping industry, and therefore included company into analysis notwithstanding its larger size).

22 *See, e.g., Mirant*, 334 B.R. at 836 (compiling cases and holding same); *Exide*, 303 B.R. at 62 n.29.

23 *See Mirant*, 334 B.R. at 819-20 (noting that troubling aspect of comparable companies analysis is that all comps are treated as equal indicators of value and are treated as sharing industrial typicality with debtor).

24 *Emerge Energy Servs.*, 2019 WL 7634308 (Bankr. D. Del. Dec. 5, 2019).

25 *See generally id.* at *1-3.

26 *Id.* at *4.

27 *Id.* at *5.

28 *Id.* at *7 (noting that these two inputs increased debtors' midpoint TEV by $122 million).

29 *Id.*

30 *Id.*

31 *Id.*

32 *Id.*

33 *Id.* at *8.

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excluding these two companies from the analysis decreased TEV by $78 million.[34]

The parties also disputed the use of market value of debt versus face value as an input for calculating a range of multiples for the set of comparable companies.[35] As previously mentioned, financial data, including debt, equity value and excess cash, is used to calculate the comparable companies' TEVs. Those TEVs were applied to projected EBITDA to derive a range of multiples, which was then applied to Emerge's EBITDA to arrive at its TEV. The unsecured creditors' committee's expert used the face values of the comparable companies' debt, while Emerge's expert used market value.[36] Under appropriate circumstances, both experts acknowledged using the market and face values of debt in calculating a range of multiples in past valuations. However, Emerge's expert testified that using the market value was more appropriate in this instance because the company's debt was trading at a significant discount-to-par value, which indicates distress and that the debt might not be repaid in full. The committee's expert countered that the company's equity trades had material value, indicating that the debt would be repaid in full, thus justifying the use of face value of debt. The court recognized that there is conflicting literature on whether to use face or market value of debt and stated that the decision is subject to the expert's discretion. In the end, the court could not conclude that the decision to use market value of debt by Emerge's expert was unreasonable, which had the effect of decreasing TEV by an additional $82 million.[37]

Conclusion

In ruling on these two issues, the bankruptcy court found that the committee's midpoint TEV should be reduced by a total of $122 million to $268 million.[38] Thus, even if the court found in favor of the committee on every remaining valuation issue (*e.g.*, whether adjustments should be made to comparable company analysis due to the severe damage to the mine, the appropriate size of premium under DCF, whether to use the debtors' *pro forma* capital structure or a hypothetical industry capital structure in its DCF calculation, whether to account for "normalization" of operations and how to value one of the company's nonoperational facilities), Emerge's calculated TEV would still not surpass the debt hurdle of $317 million and, accordingly, would not put unsecured creditors "in the money."[39] Therefore, the court overruled the committee's objections related to valuation, finding that the plan was "fair and equitable" under § 1129(b)(1). This case, and these two valuation decisions in particular, demonstrate the imprecise and subjective nature of company valuations. Understanding the basic valuation methodologies is the first step, but understanding the way in which parties can manipulate (and justify) value is more critical when entering a valuation fight. abi

34 *Id.*
35 *Id.*
36 *Id.*
37 *Id.*
38 *Id.* at *7.
39 *Id.* at *8-10.

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