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What is the purpose of a business valuation in an LBO in hardship?

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Appraising a financially troubled business in an LBO is a virtuous exercise that provides lessons. On the one hand, it provides an understanding of where the volatility of the value of the shares comes from. On the other hand, it demonstrates that holding the share of such a company means holding an option! This change of perspective helps to explain many of the decisions made.

There are many companies that have been purchased recently through a leveraged buy out (LBO) and now find themselves in a difficult position: they are heavily in debt, based on an asset base value that is called into questioned today, and, for some, they are no longer able to meet their commitments with their creditors (broken covenants, deferments, etc.). Detractors of financial theory blame investor bankruptcy, lending or advising bankers, or even the financial community in general. Even worse, it would be pointless to try to appraise a financially troubled business! However, there are some lessons to be learned from the valuation of these companies[1], lessons that may prove to be strategic during this period of turbulence.

“The share of a financially troubled company is a kind of option!”

First, recall that all modern methods of financial valuation follow a three-step process:
- Initially, the market value of the company’s business portfolio (or “entity value”) must be estimated, without taking into account (or independent of) its financing arrangements.
- Then, the value of the net financial debt is estimated.
- Lastly, the value of the shareholders’ equity is deduced through subtraction.

Let’s look at a simple example. Imagine a company, Waterloo SA, whose business portfolio is worth €100 million (which is therefore the entity value). This company shows debt of €99 million. That leaves only €1 million (equity value) to be distributed among the shareholders of this company in a dreary situation.
Now imagine that from one year to another, the entity value of Waterloo SA increases modestly by 1 percent (from €100 million to €101 million). If the debt level has not changed, the equity value can then be estimated at €2 million. The asset base of the shareholders has therefore doubled, while, ultimately, the value of the assets, or the business, has made little progress. Financial theory teaches us here that this involves the simple implementation of the “leverage effect”, which mechanically explains the volatility of the value of companies on the verge of bankruptcy. The downside is that leverage, profitable for the shareholder when business starts back up, is accompanied by a substantial risk to be taken by the shareholder. Indeed, if the enterprise value had fallen by only 1 percent, the entire equity value of the company would have evaporated!

We can look at the problem in a slightly different way. Imagine that Waterloo SA is acquired by a buyer (Titanic Capital Partners) at a price equal to its “fair value”, or €1 million. This entrepreneur is faced with a rather simple dilemma:
- After one year, if the business has grown, it can repay its acquisition debt and benefit from the created value, once this debt repaid.

- Conversely, if the value of the business has declined, the buyer will lose its original stake, which is ultimately a rather limited loss in light of the total value of the business portfolio.

Financial theory offers an original reading of this situation: the buyer is in a position fairly close to that of the holder of a call option on financial markets. Recall that in its simplest form, a call option provides its holder with the possibility, but not the obligation, to buy an asset at a specified date and for a price set today. The buyer of a financially troubled company is therefore the holder of an option to purchase the assets of the company in exchange for future repayment of the debt (the price to pay to “hold” the assets). Financial theory sheds light on the future behaviour of this buyer; the value of an option depends primarily on the risk of the underlying asset: the higher the risk, the higher the value of the option. Logically, the buyer of a company, who considers its share to be an option, has every incentive to seek to maximise the risks taken by the company in order to maximise its share value. Between two industrial operations, even between two strategies business, it will choose the one offering the highest potential gain (even if it is the riskiest for shareholders and other financial backers) and not those providing the greatest gain on average!

Thus, we can explain the fad in recent years in many companies undergoing an LBO of selling property or industrial assets directly necessary for operations. In principle, in an efficient market that values assets at their fair value, these transactions should have no impact on the capital wealth of shareholders. So, what would be the interest in carrying out such transactions? By selling their property assets, companies in an LBO substantially modify their risk profile by increasing their operating leverage: they are now under additional pressure through the payment of substantial rent for the use of the operating property that was sold! The shareholders controlling these companies deliberately choose a riskier strategy, thus following reasoning in line with the “logical option” described above.

These are a few simple lessons that explain the reasoning behind some of the decisions made in financially troubled companies, but also the increase, sometimes explosive, in their value. In fact, just like options on financial markets, the equity value of financially troubled companies can vary quite significantly over short periods depending on whether certain risks are materialised!

From these few analyses, it can be concluded that in dealing with a financially troubled company, the valuer should expect to obtain a relatively wide range of estimates reflecting both the extent of the risks and the magnitude of the leverage effects (operational and financial) incurred by the shareholders of these companies. In their work, valuers must also work to understand and consider the economic model of the company that they are appraising. Thus, the valuer must be able to estimate the impact of key issues from which it may or may not able to recover: scenarios of changes in unit selling prices, production costs, reorganisation of production structures, renegotiations of debt or its covenants, contributions of funds by a new potential partner, etc. Even more than for a healthy company, when it comes to appraising a financially troubled company, the valuer must be able to explain the magnitude of the range of estimates obtained. This range of values is representative of many possible future development scenarios for the company. Thus, by performing the valuation of a financially troubled company, the valuer works to advise the leaders of the company by translating the operational strategies available to them into financial terms. The valuer may also provide some clues to shareholders so that they can assess the extent of the risks that they have taken and the extent of the risks that they must still incur. Thus, it offers relevant insights to convince, or not, shareholders to reinvest in a company that may be worth more than they believe.

In these times of hardship and high volatility in the financial markets, the temptation is strong for many commentators to hide behind the irrationality of investors in order to reject analysis and financial thinking. Quite the contrary, the valuation of financially troubled companies shows us that in order to understand and explain changes in the value of assets, more than ever, it is vital to go back to the theoretical foundations of finance.

1 By “financially troubled company”, we restrict our analyses to heavily indebted companies under LBO, close to but not yet within the scope of a mutual agreement procedure (special mandate or conciliation).

KEY POINTS

Financial leverage, potentially creating value for shareholders, is also a source of uncertainty.

Holders of a share in a troubled company behave like holders of an option: they have a large appetite for risk.

Two lessons too often ignored!

ABOUT THE AUTHORS

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