

Asset Value Trumps Discounted Cash Flow in Another Bankruptcy Valuation Dispute

By Yvette Austin Smith and Evan Cohen

A recent opinion in the Genco Shipping valuation trial is a reminder that the discounted cash flow (DCF) method – the usually reliable workhorse of valuation – can sometimes lead one astray. In his July 2, 2014 opinion, U.S. Bankruptcy Court Judge Sean Lane rejected DCF as a way to value the dry bulk shipping company, concluding that net asset value (NAV) provided a far better indication of value in this instance.

Genco Shipping and Trading Limited is one of the world's largest dry bulk shippers, operating a fleet of 53 shipping vessels. Owing in part to a 2007 recapitalization that added \$1.1 billion in debt to the company's balance sheet, Genco filed a prepackaged bankruptcy in April 2014. However, the company's proposed restructuring plan was subsequently rejected by the Official Committee for Equity Holders, who argued that the plan undervalued Genco and would result in the company's equity holders receiving an unfair distribution of value upon plan confirmation. To resolve the dispute, Judge Lane agreed to a valuation trial that took place in mid-June. At trial, the debtor and the equity committee both presented multiple valuation experts. Reminiscent of the valuation dispute *TOUSA, Inc.*,¹ Judge Lane's opinion highlighted that the DCF methodology can be a less reliable indication of value for a business with heavy fixed assets and uncertain future cash flows. The Court concluded that "the DCF analysis [was] not an appropriate method of valuation" for Genco and that NAV "should [have been] given substantial weight given the nature of the dry bulk shipping industry."²

Net asset value assumes that the value of an operating business is significantly determined by the sum of the value of the company's assets, less its liabilities. Under this methodology, asset values are commonly measured at market or replacement value. The company's assets will include traditional fixed assets (e.g., machinery and equipment) as well as other quantifiable assets such as contracts and backlog. The NAV method ascribes minimal (if any) incremental value to the fact that the individual assets have been aggregated in a specific configuration, say, under a specific management team or brand name.

Companies with relatively few or valuable but heavily depreciated fixed assets, significant intangible assets, strong brand names, or highly acclaimed management teams would tend to be inaccurately valued using an NAV approach. Conversely, companies long on fixed assets and short on intangible assets, such as an asset-rich company in

¹ See: In re: *TOUSA, Inc. et al.: Official Committee of Unsecured Creditors of TOUSA, Inc. et al., v. Citicorp North America, Inc. et al.*, Case 08-01435-JKO, U.S. Bankruptcy Court S.D. FL (Fort Lauderdale) and "Why do Solvency Opinions Fail?" by Yvette Austin Smith (you may contact the author for a copy).

² The Court placed secondary weight on market-based approaches to value Genco.

bankruptcy, may find that the NAV approach provides a better indication of value. This is all the more true because companies in financial distress or outright bankruptcy pose special problems for finding both the right discount rate and an accurate measure of expected cash flows. It may also be hard to find valid market comparables.

Given the many types of companies for which an NAV analysis would *not* accurately measure value, it is generally the least-used valuation methodology. Income-based approaches (most commonly DCF) and market-based approaches (generally, comparable company analysis or precedent transactions) are far more common. Even when multiple valuation methodologies are used to triangulate an estimate of value, it is often said and borne out in case law that courts place the greatest reliance on DCF analysis in valuation litigation.

Both valuation experts and the attorneys who retain them should be cautious of the companion reflexive tendencies to over-emphasize DCF and under-emphasize NAV when valuing a business. While DCF will continue to figure prominently in valuation analysis, the presence of financial distress, or of highly-speculative or uneven cash flows, could be reasons to reconsider (or give lesser weight to) a DCF analysis in a specific situation. *Genco* and *TOUSA* are both useful reminders of this exception to the rule.

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