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Business crisis management: necessary economic valuations

Expert's opinion

Corporate crisis and business valuation

*by **Fabrizio Garofoli***
Head of Insolvency - Bernoni Grant Thornton

The regulation of corporate crisis is in many ways similar to the business valuation process.
Recovery processes, both in court and out-of-court, whether ongoing or not, often involve solutions such as a business transfer or even a business lease to a third party capable of continuing the activity while safeguarding its value through so-called indirect continuity.
Within this scenario, there arises the need to define the "business value" and thus to carry out an evaluation in a situation other than normal operations.
In practice, the main reasons for an expert's valuation of a distressed business are the assessment of the (i) transfer value; (ii) suitable lease rental; (iii) transfer value in a hypothetical compulsory...

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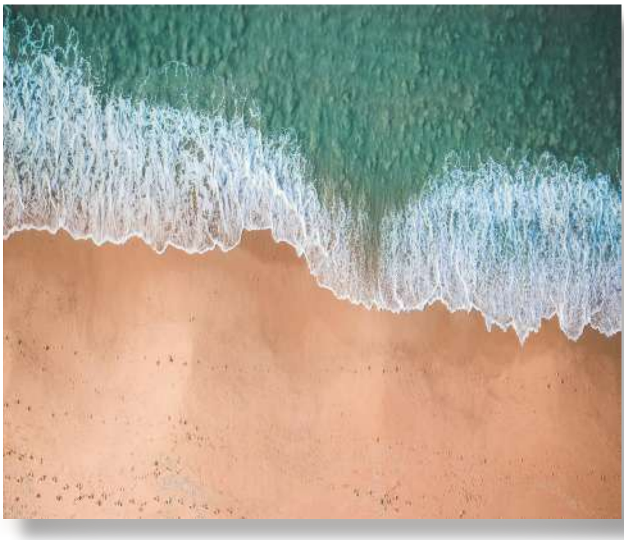

Overview

Valuations of distressed companies

*by **Giulio Tedeschi***
Partner - Bernoni Grant Thornton

Valuations of the economic capital of an entity generally lead to acquisitions and, even more so, to growth and development operations.
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The reform to the business crisis code (legislative decree no. 14/2019 and following amendments) aims to introduce structural measures for the recovery of distressed companies in crisis, safeguarding their economic – but not only – value. It must be underlined that "crisis" is defined as...

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Focus on

Crisis and critical variables in the application of the DCF method

*by **Leonardo Fortunato***
Director – Bernoni Grant Thornton

The valuation process, whatever the context and regardless of the object of analysis, is inherently subject to a certain risk concerning the validity of the assumptions made (in most cases related to the scope of the evaluation methodology applied) and the resulting outcomes. The task of diversifying this risk falls to the so-called Expert, who, through their reasonableness, independence and professionalism, as well as the minimisation of possible variables assumed 'uncritically' (i.e. free from documentability element), must strive as far as possible to achieve relevant, recognisable and which, as already...

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Overview

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Valuations of the economic capital of an entity generally lead to acquisitions and, even more so, to growth and development operations.

The market economy of most recent years (COVID – geopolitical context and wars – etc.) shows how market crisis can represent a widespread and physiological phenomenon. The reform to the business crisis code (legislative decree no. 14/2019 and following amendments) aims to introduce structural measures for the recovery of distressed companies in crisis, safeguarding their economic – but not only – value.

It must be underlined that "crisis" is defined as "the debtor's situation that makes insolvency likely and that shows itself as the inadequacy of prospective cash flows to meet obligations over the next 12 months" (art. 2, para. 1, lett. a) of the business crisis code). On the other hand, "insolvency" means "the debtor's situation that shows itself as defaults or other external factors, which demonstrate that the debtor is no longer able to regularly meet their obligations" (art. 2, para. 1, lett. b) of the business crisis code.[1]

In brief, both definitions above, according to a regulatory interpretation, indicate that the "crisis" pathologically precedes the occurrence of "insolvency". Therefore, it is possible to intervene and solve the crisis situation to avoid insolvency, which, instead, is irrevocable (and leads to compulsory winding up). Identifying the most suitable measures for safeguarding a distressed company with a view to restructuring and continuity shall be based on regulatory instruments that require the performance of the valuations examined in this article.

In other words, valuations are also crucial within business crisis to support the regulatory instruments introduced to overcome the crisis and rebalance the company's economic and financial position.

The most qualified authors analysed this aspect and pointed out that the consequences of the business crisis can be more or less serious depending on how quickly it is identified and how it is managed.[2]

[1] The norm invites to a purely financial interpretation: the inadequacy of financial flows or the impossibility to pay one's obligations. However, the well-established assertion that a financial crisis is objectively a consequence of an economic crisis cannot be ignored; as such, the latter precedes a financial crisis.
[2] See M. Bini "*Le valutazioni delle aziende in crisi*" (Valuation of distressed companies) EGEA 2025.

Therefore, valuations are useful not only as technical instrument to support the recovery measures provided under the business crisis code, but also as a tool for a conscious management, since an informed valuation of the company in crisis can represent a crucial diagnosis and management tool.

Valuations can help not only identifying the seriousness of a crisis, but also understanding its causes: in fact, valuations within the crisis management phase should be aimed at assessing the actual value of corporate assets, which is the starting point for crisis resolution.

A valuator, besides identifying the particular aim of a valuation, should be independent from self-interests, as well as from the analysis of restructuring plans that may be subject to distortions, but which represent the crucial starting point to perform valuations.

This issue of TopHic includes the expert's opinion (by Fabrizio Garofoli), which will analyse the cases in which the Business crisis code expressly requires the involvement of an expert for the performance of valuations required under the many different procedures, as well as an article (by Leonardo Fortunato) analysing the possible valuation methods to be adopted within the specific context of companies in financial crisis – taking into account critical aspects, perspectives, and practical applicability of the methods.

In conclusion, we would like to point out some aspects that involve the professionals dedicated to such area. First of all, what are the steps required to perform a valuation of a distressed company?

The common practice identifies at least four phases: (i) the crisis analysis, (ii) the structure of the valuation system, (iii) the analysis of the restructuring plan, (iv) the valuation methods to be selected and applied.[3] With particular reference to the last phase, it should be pointed out that a valuator must first consider the risks associated with the various value configurations that are the subject of the valuation. In fact, a distressed company generally requires an operating restructuring and, therefore, can be more or less intense and risky. The approach to valuation must identify the steps that the company intends to take to realize its restructuring, hence the risk of the plan and its failure risk.

The risk of the plan is in all value configurations adopted, which are based on a continuity perspective (recoverable value).

The plan failure risk, on the other hand, is only in some value configurations, which are based on a "mixed" perspective, i.e., providing either the possible realization of the plan, or the possible liquidation of the company.

All these aspects must be carefully considered, as the models and methodologies that characterise most valuations are not automatically applicable to this type of valuation. In fact, it is more difficult to find comparisons with market values or comparable assets, as well as useful elements for estimating a replacement cost.

It is a professional activity of an interdisciplinary nature that requires a high degree of attention.

[3] OIV – *Organismo Italiano di valutazione* (Italian valuation organisation) - Discussion paper n.1/25: "*La valutazione delle aziende in crisi*" (Valuation of distressed companies)

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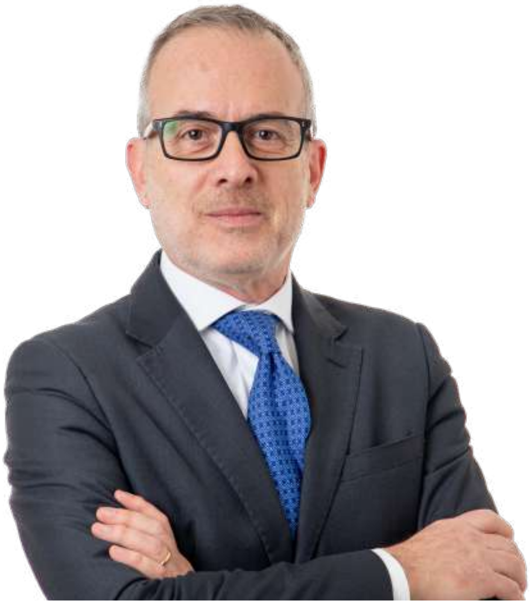

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Recovery processes, both in court and out-of-court, whether ongoing or not, often involve solutions such as a business transfer or even a business lease to a third party capable of continuing the activity while safeguarding its value through so-called indirect continuity.

Within this scenario, there arises the need to define the "business value" and thus to carry out an evaluation in a situation other than normal operations.

In practice, the main reasons for an expert's valuation of a distressed business are the assessment of the (i) transfer value; (ii) suitable lease rental; (iii) transfer value in a hypothetical compulsory liquidation scenario (be it through the transfer of the corporate equity or of the single assets); (iv) value reserved to shareholders upon conclusion of the recovery process; (v) value for possible extraordinary operations.

In similar circumstances, the relevance of an expert valuation is twofold: on the one hand it provides an estimate of the value generated by the positive outcome of the business turnaround process undertaken by the entrepreneur; on the other hand, it provides significant information for credit purposes, in order to favour an informed assessment of the economic and financial convenience of the debtor's proposal.

The expert must carry out his evaluation independently, adopt a suitable professional scepticism, analyse the assumptions underpinning the Plan, the analysis performed by the attestor or subject in charge of the IBR and, should he believe there are further elements not considered in the Plan, make the appropriate adjustments.

By way of example, the evaluation of a distressed company must take into account endogenous variables, such as the potential loss of key resources, the evolution of the relationship with key suppliers, the contractual conditions proposed to clients, as well exogenous variables such as the dynamics of the reference industry and the market trend, which could influence the sustainability of the turnaround process.

The valuation

According to the Italian valuation principles, experts are required to indicate in their report:

- the aim
- the object
- the unit
- the value configuration
- the date

It is our opinion that, once clarified the prerequisites above, it is essential that the expert, in presenting his logical argumentative process, carefully reflects on the question of whether the valuation of a distressed company should be carried out based on its historical trend, on its current situation, or on the perspective industrial plan that includes the recovery plan.

The valuator is required to jointly consider and analyse all three phases, acknowledging that the latter - i.e. the perspective Plan - represents a potential scenario in which data are mainly the result of estimates.

The historical trend, in most cases, cannot be considered as the sole reference parameter, since the results attained could reflect a significantly different corporate structure than the current one and the one after the recovery (these are, in any case, key data on which to focus attention). Therefore, when analysing results, it is crucial to identify the phase of the company's lifecycle when the valuation is carried out, as well as the variables which allow it to attain the performance recorded.

In short, it is key to understand whether the valuation should be set up basing on an "as is" or "to be" approach.

In the first case, the valuation does not keep into account the assumptions underlying the recovery plan, but rather provides a snapshot of the company's situation, operating adjustments in order to specifically identify the scope of the potential disposal.

In the second case, instead, the valuator must consider the value in relation to the recovery plan and focus his attention on the underlying assumptions. It is crucial to quantify the risk that the hypothetical recovery plan may deviate from that expected trend over the financial years (execution risk), analyse how the variations could influence the plan and whether the company has foreseen any corrective measures capable of ensuring compliance with the original strategy (stress test scenarios, sensitivity analyses and the allocation of generic risk provisions in the recovery plan are therefore essential).

Moreover, assuming that the plan may lead to an increased degree of uncertainty over time (plan timeframe), it is advisable to define an incremental discount rate different for each future financial year.

As for the identification and quantification of risks - an activity which directly impacts on the determination of the discount rate to be adopted (WACC, Ke) - the expert must pay specific attention to the risk of double counting that the recovery plans devised under a crisis include prudential assumptions ant therefor the available data already reflect prudential estimates.

Focus on

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In a context of 'crisis', which, as already mentioned, refers to 'the economic and financial difficulty that makes the debtor's insolvency likely, and which for companies manifests itself as the inadequacy of prospective cash flows to meet planned obligations on a regular basis', the expert plays a key role since he/she is assigned the task of quantifying, from an economic and financial perspective, company prospective or liquidity scenarios (in some cases also related to individual assets), on the results of which depends the possible satisfaction of the related stakeholders (shareholders, creditors, lenders) as well as the choice of the best strategic option from a procedural perspective (e.g., transfer, liquidation).

After recalling the essential role of the expert, though in very general terms, it is therefore worth highlighting the main variables that can undermine the correct implementation of methodologies and the identification of underlying correlations in the context of a company valuation in 'crisis'.

Valuation methods

As also pointed out by the OIV (Italian valuation body) in its latest discussion paper (No. 1/25) there should be no specific methods for the valuation of distressed companies, as the "traditional" methods - which can be adapted to possible different variations - are, in principle, sufficient for determining the value of business assets, even in a context of "crisis".

Although it is true that traditional methods (i.e., income approach, market approach, cost approach) are readily applicable even in contexts of "crisis", for reasons of brevity, the following section will refer to the main points to be considered when applying methods based on cash flows (the so-called Discounted Cash Flow Method) in a context of possible business continuity once the state of crisis has been ascertained, as these are considered to be more applicable and used in the contexts under analysis.

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Key points to consider when using the DCF method

As summarised by the OIV (document mentioned above), when applying cash flow-related methods, the main points for the expert to consider are "essentially" the following:

- **The risks inherent in the business plan supporting the corporate restructuring project:** first of all, it is pointed out that the development of a business plan is a fundamental part of a corporate restructuring process aimed at medium- to long-term continuity ('The plan identifies the steps through which the company intends to carry out restructuring'). From a primarily evaluative perspective, the development of a business plan - in such a context - is particularly subject to a number of inherent risks, which can be summarised as follows: A) the typical risk of a business plan, which is generally inherent to i) systematic risk (and, theoretically, difficult to diversify), ii) scenario risk (i.e., determining cash flows based on specific assumptions), and iii) execution risk, i.e., when the plan itself provides for specific initiatives/strategies to be undertaken. These risks, as also pointed out by the OIV, must be taken into consideration by the expert both in relation to a preliminary analysis aimed at assessing the correct (basic) construction of the plan itself and, above all, in weighing up an appropriate discount rate that can properly summarise these risks, always taking into account the specificities under analysis.

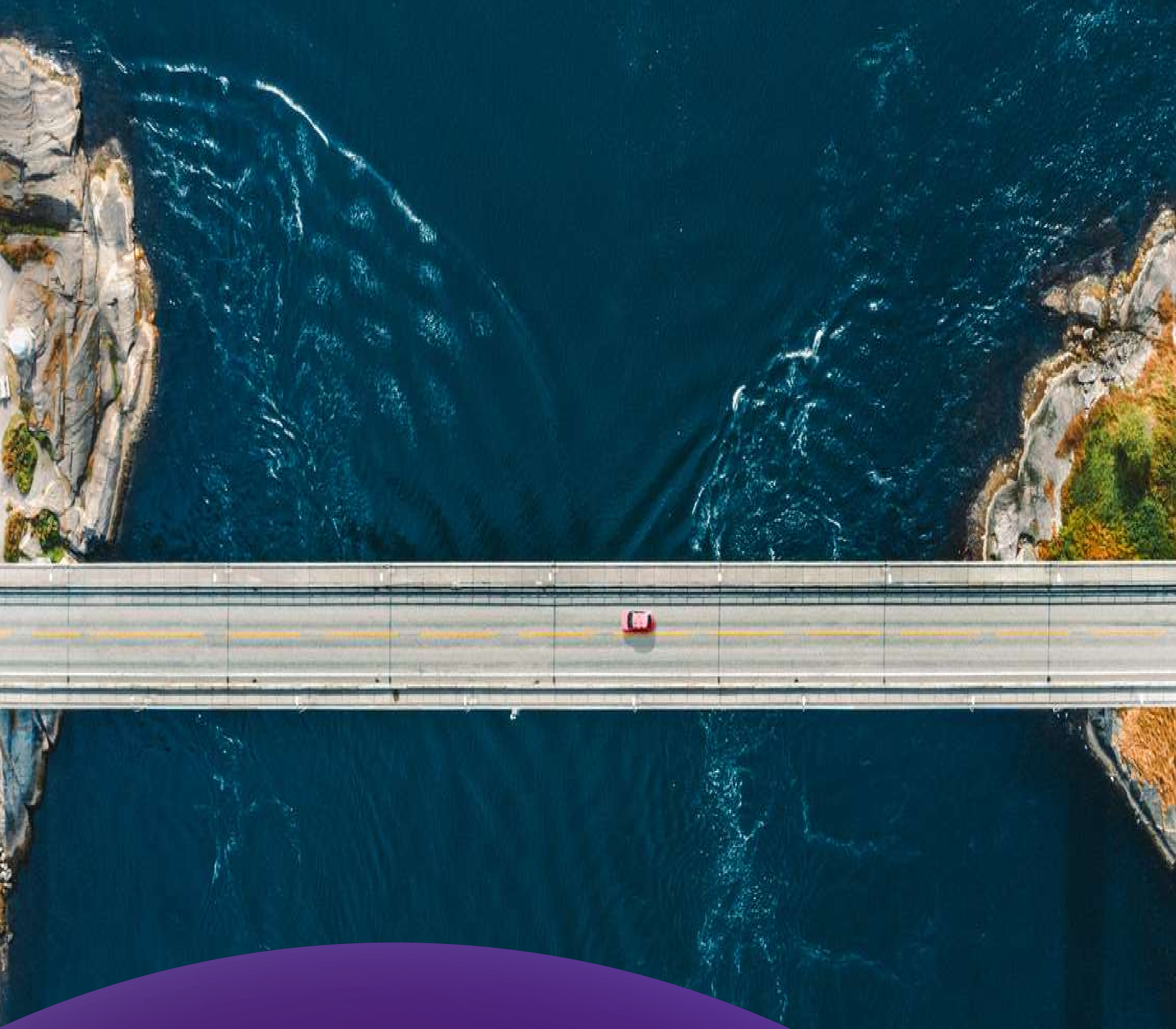
  Another intrinsic risk is the possibility of failure of the plan, which in turn must be weighed in the variables underlying the discounting of the reference cash flows (e.g., by strengthening the discount rate through specific rates or by independently calculating an estimate of the probability of default of the plan itself).

- **Identifying a suitable discount rate of flows originating from the plan:** beyond the possible "crisis" scenarios, the identification of a suitable discount rate always plays a key role for the correct calculation of the actual value of expected flows. In short, two of the most important macro-components to be considered when calculating a discount rate are: i) first of all, the variables which summarise the systematic risk and the "generic market risk" which in most cases is assessed through a CAPM approach; ii) secondly, the identification of all those "additional" rates aimed at customising the discount rate to be applied to the case at stake (consider the scenario and/or execution and/or plan failure risk). Very often, when considering the abovementioned two macro-components - also given the prudential approach the expert must adopt in such contexts - there is the possibility of double counting the valuation of the same risk (e.g. a scenario risk also considered as an execution risk).

- **Estimating the Terminal Value:** the terminal value is an additional value to be determined carefully and attentively (usually a significant part of valuation results depend on this variable). In a "crisis" context, it will most probably not be sufficient to determine it on an "historical" basis, but rather - as also suggested by the OIV - analytically. Many of the variables taken as reference to determine multi-year flows can actually undergo considerable changes in an "indeterminate" perspective, such as the return to a functional and thus income stability. By way of example, it is worth considering the trend of revenues or, more specifically, the effect of long-term CAPEX (against investments already made during the plan, which do not need repeat significant investments) or also the tax variables (e.g. the use of previous tax losses to abate future income). In addition to what briefly explained above, it is clear that the expert, in an Income approach logic (i.e. DCF), must also keep into account other factors, with the final aim to determine a value as specific and as objective as possible (consider, for example, the financial variable of the plan both for its effects on flows and as for the discount rate, or contractual arrangements in a "crisis" context underlying the generation of revenues, or the "regenerated" movement of net working capital). It is advisable, where applicable, that the outcome of the analyses be validated with the application of an alternative valuation method (e.g. the multiples method, with all necessary precautions required by the application of such method in a crisis context) aimed at confirming the results obtained by the main method chosen.

Closing remarks

The methodological application and the choice of the underlying and related significant variables are key processes that the expert - also and above all in a "crisis" situation - is required to deal with when devising a valuation project. In a context where a company is not carrying out normal business operations, attention to peculiar and fundamental aspects - both endogenous and exogenous in a "crisis" - is key to achieving consistent and reasonable valuation results. When planning the method to adopt (e.g. as for DCF), the expert must valorise different risks and scenarios, which require specific targeted interventions aimed at weighing up "additional" and hardly predictable variables.



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