# Valuation in a multi-tiered debt structure

In a recent case[1], the High Court concluded that it was right to sanction schemes of arrangement which formed part of a wider debt restructuring that excluded out-of-the-money junior creditors. In doing so, it valued the distressed companies on a going concern basis.

## Background

Three group companies[2] sought sanction of schemes of arrangement[3] in order to implement a debt restructuring. The group's indebtedness comprised senior debt and subordinated mezzanine debt. The overall effect of the proposed restructuring would be: the transfer of the group's assets to a new group of companies; the novation of a large part of its senior debt to that group (with a small part of that debt remaining in the existing group); and the rest of the senior debt being substituted by the senior lenders taking equity in the new group. No assets were to be left in the existing group to pay the mezzanine lenders, who would thereby be shut out of the restructuring.

The justification for this approach was that the mezzanine lenders had no economic interest in the group because the value of the assets (or the value of the group as a whole) was significantly less than the value of the senior debt. On that basis the companies proposed schemes only with the senior lenders. The mezzanine lenders would not be parties to the proposed schemes and therefore were not given the opportunity to vote on them.

The schemes had been approved by senior creditors at the relevant meetings by the requisite statutory majority, although they did not have unanimous support. The mezzanine lenders challenged the schemes at the sanction hearing, their key argument being that they did not accept that the value of the group was less than the value of the senior debt.

## Principles applied by the Court

The Court affirmed the following principles as applicable in this case:

- A company is free to select the creditors with whom it wishes to enter into an arrangement and need not include creditors whose rights are not altered by the proposed scheme.
- It is not necessary for a company to consult creditors who are not affected, either because their rights are untouched or because they have no economic interest in the company.
- If there is a dispute, the court is entitled to ascertain whether a purported class actually has an economic interest in a real, as opposed to a theoretical or merely fanciful, sense and to act accordingly.

## Valuation evidence

The scheme companies had undertaken various valuation exercises.

The first of these valued the group on a going concern basis, the objective of the report being to come up with a figure (or range of figures) for "*the amount that the business is expected to realise in a sale at the current time*". It adopted three methodologies: "income approach" (a discounted cash flow ("DCF") basis with an added "*alpha factor*" to the cost of capital to reflect uncertainty in the market and the impact of the present credit crunch on the availability and cost of financing – which depressed the final valuation figure); a market approach; and a leveraged buy-out analysis.

The second involved undertaking a third party sales process with a view to seeing if a buyer for the existing group could be secured.

The third involved valuing a number of the group's sites and then extrapolating an overall value from the valuation of those sites on both a restricted sale basis

(swift sale without a full marketing campaign, as a mortgagee would be entitled to do) and a full market value basis.

All of these valuation exercises showed that the value of the group was very significantly less that the value of the senior debt (even if the "*alpha factor*" were stripped out).

The mezzanine lenders produced evidence which relied upon a DCF analysis in which the group is valued on an ongoing basis (which they relied upon as showing value for them). The Court noted that this report did not set out a view of the value but instead undertook a simulation involving repeated calculation of the DCF valuation, using random sampling of input and assumptions, and then aggregating the result into a distribution of probabilities of different valuation outcomes.

## The Court's conclusions on valuation

The Court held that, for the purposes of this case, a going concern valuation is appropriate.

The Court noted that it was entitled to look at the various valuations and to determine the extent to which they assist it on the issue of valuation. Referring to the evidence produced by the mezzanine lenders, the Court commented that the technique used seemed to produce not so much a range of values, professionally assessed, but a range of possibilities. Although they might be used as a step towards valuation (where some more judgment has been applied), they are not themselves a valuation.

The Court held that "*a proper approach to valuation in a case such as this requires some real world judgments as to what is likely to happen ..., rather than a range to which other ranges are applied in a series of random calculations to come up with some mechanistic probability calculation*".

It concluded that it did not give as much weight to the mezzanine lenders' evidence as it did to the valuation exercises carried out by the group companies. As an exercise of assessing what a third party purchaser would pay, it found the mezzanine lenders' evidence to be very unconvincing.

The Court then considered whether the mezzanine lenders' evidence supported an analysis that the group had an "intrinsic value" which was different from its current market value, that is, whether senior lenders are getting an unfairly good deal because, in the present market, sales are unlikely to take place but when economic conditions change the same group will be perceived to be more valuable (and the senior lenders will take the benefit of that). The Court concluded that the mezzanine lenders' evidence did not demonstrate with sufficient clarity that market conditions are currently giving senior lenders an unfairly good deal.

## Directors' duties

The Court also addressed a number of other issues raised by the parties. *Inter alia*, it confirmed that, in discharging their duties to creditors, the directors were not on the facts required to have bargained for something to be provided to the mezzanine lenders.

Focusing on the question of who should have been doing the bargaining on behalf of the mezzanine lenders, the Court observed that they were a separate negotiating party, trying to protect their own position - while this might not in every case absolve the directors from trying to take additional steps to protect them, in the present case it went a very long way. In any event, on the facts, the board was not in a position to bargain for some additional return to other creditors if this was resisted by the senior creditors.

## Comment

The Court was willing to allow out-of-the-money junior creditors to be excluded from a restructuring where the value breaks in the senior debt. As a result we may see other senior lenders in a similar position looking to push forward a restructuring.

In light of the Court's application of a "going concern" basis, going forward it may be easier for creditors in other cases to argue that this (as opposed to, for instance, a liquidation basis) is the appropriate method of valuation.

However, the Court's approach to both of these points was specific to the facts of this particular case and so it seems unlikely that we have seen the end of either of these debates.

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## End notes

1 [2009] EWHC 2114 (Ch)

2 Bluebrook Limited, IMO (UK) Limited and Spirecove Limited

3 s895 Companies Act 2006

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