



Experts Left 'In the Dark' By Deliberately Manipulated Management Projections

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***In re Nellson Nutraceutical, 2007 Bankr. LEXIS 99
(January 18, 2007)***

It's every valuation expert's nightmare, learning after-the-fact that the long range financial plans provided by management did not represent their "best and most honest thinking," to use the Bankruptcy Court's more delicate phrasing.

And that wasn't the worst of this Chapter 11 case, concerning a privately held manufacturer of nutrition bars and supplements. To be "in the money" on their investment, the principal equity holders needed to have the debtors' enterprise value declared in excess of \$365 million. After screening potential valuation analysts to pre-determine their methodologies, the investors and their attorneys sent the selected expert certain values to be attributed to the growth initiatives; and then discussed in private as well as email how to "figure out a way" the expert could assist the investors.

Further, the investors hurriedly pushed through a "puffed up" business plan for the debtors, which layered on growth initiatives with inflated revenues and EBITDA projections; ignored price compressions and increased market competition; and eliminated "millions" in capital expenditures (CapEx). The latter turned out to be the "way" the investors could reach the equity hurdle—but in a decision late last year, the Court struck their expert's report for his use of the "maverick" Cap Ex metric in his DCF analysis (for an abstract of that decision, see the January 2007 *BVU*).

The Court does not mince words in condemning these events:

In sum, [the investors] utilized [their] control over [the debtors] to manipulate both the business

planning and valuation process to come up with an artificially inflated enterprise value...to claim some residual value for their existing equity position. There is no other credible interpretation of the evidence before the Court.

The emphasis appears in the original opinion, which next poses the Court's dilemma: When each of the three remaining experts in the case (retained by the various creditors) relied on the compromised management projections, "how does the Court rely on the expert testimony?" In particular, should it exclude their discounted cash flow analyses, or should it continue an already lengthy and expensive trial to permit revised reports?

Creditors' experts all credible

The Court specifically exonerated the experts, who applied "usual and customary" valuation techniques; and who "justly relied" on the debtors' information, which was "deliberately inaccurate." Accordingly, the Court decided to: (i) accept all three expert opinions; (ii) adjust them for perceived errors and inaccuracies; (iii) weigh them according to credibility; and (iv) adjust the weighted average to account for the debtor's performance since the appraisals. (Note: the appropriate valuation date was the date of the hearing, and expert reports, prepared several months prior, helped "assist" rather than supplant the trier-of-fact in its determination of enterprise value.)

The Court did not completely absolve the debtors' expert, noting he'd sent a draft appraisal to the debtors' Board using a traditional DCF analysis that did not reach the desired equity. During a "lively and lengthy" telephone call, Board members apparently told the appraiser it would be a "good idea" to use the CapEx methodology. A week later, the Board received his new report using the CapEx methodology, and approved it immediately.

Valuation highlights

After describing the low-points of the proceedings, the Court conducted a careful analysis of the three

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expert reports by Richard Braun, ASA (FTI Consulting, Inc.), William Hardie (Houlihan Lokey Howard & Zukin), and Russell Belinsky (Chanin Capital Partners). All three used a traditional DCF analysis as well as a comparable company and comparable transaction analyses—and all three reached the same basic conclusion, that “the [debtors’] enterprise value is *not* sufficient to leave any value for [the investors].”

Their median values were also within 10% of each other, from a low of \$314 million to a high of \$349 million, with the third at \$322 million. But all three testified they would have to reduce their respective valuations significantly, given the extent of the man-

agement manipulations (revealed at trial) and the debtors’ severely deteriorated financial performances since the reports.

Factoring these points into its stated adjustment/weighting procedure, the Court determined the debtors’ enterprise value. Highlights of its analysis include:

1. *Separate consideration of ‘growth initiatives.’* Only one expert used a separate discount rate in his DCF analysis to account for the debtors’ growth plans, thereby assigning a separate value to the increased risk of these income streams as opposed to folding the risk into the discount rate applied to the base business. The debtors argued this double-counted the risks of the growth initiatives; the Court disagreed, noting the technique was acceptable when certain projects are riskier than the entire business.
2. *No ironclad rule regarding management projections.* While precedent generally favors management projections, courts should examine the track record and motives of management to determine the credibility of their forecasts on a case-by-case basis.
3. *Application of risk premiums.* In determining the appropriate discount rate, one expert used a 2.05% “emergence risk premium” and the other a 6% company-specific risk premium (CSRP) to account for the increased risk in the debtors’ earning capacity post-reorganization. By any terminology, the debtor claimed the risk premiums inappropriately considered market perceptions, but the Court found they adequately reflected bankruptcy’s potential impact on future earnings. However, it also found the 6% CSRP excessive, and adjusted it to 4%.
4. *Selection of terminal multiples.* The debtor said two experts should have derived the terminal multiples for the DCFs from the comparable companies analysis rather than the comparable transactions, which contained “stale” sales over two years old. The Court said the experts had correctly derived their multiples from transactions data, as their estimations concerned the debtors’ worth to an acquirer. Moreover, there is no “bright line rule” branding transactions older

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than two years as irrelevant to a comparable transactions analysis: It's the similarity that matters.

5. *Valid criticism of selection of multiples.* Two experts had failed to use the median EBITDA multiple of the selected comparable companies and transactions analysis; instead, they used a lower figure based on “expert judgment and not simple arithmetic,” reflecting the critical qualitative differences between the debtors and the guideline companies/transactions. “That may be so,” the Court said—but then noted that where an expert preferred “judgment” over math, the effect was generally to lower enterprise value, even in face of evidence that it should be higher.
6. *Size risk premium.* Similarly, according to the math the debtors fit into the 9th decile of Ibbotson data. The resulting equity value straddled the 9th and 10th deciles, and though two experts had resolved this by using the micro-cap risk premium, one expert had chosen to use the 10th decile data—which was an error, the Court said, as it helped “pre-determine” the conclusion of enterprise value.
7. *Non-operating assets.* One expert properly excluded a large debt from the debtors' cash balance, and properly attributed a zero value to certain tax attributes where these were highly uncertain.

Can you recite the Gordon Growth formula?

The Court found all of the experts highly-qualified and experienced, even those the debtors challenged for lacking formal valuation training and/or credentials (two were attorneys/investment professionals). Each had made some errors—including one who was unable to recite the formula to the Gordon Growth model on cross examination. But overall, each expert had established and maintained his credibility.

Notably, the Court singled out the accredited appraiser as the most persuasive, not only for his valuation training but for his independence, as he'd had no knowledge of the debtors' secured debt prior to the valuation. The Court weighted his report 40%, the others 30%, to reach its final conclusion of the debtors' enterprise value at \$320 million.