Companies in Distress: Valuing the Impaired and Currently Unprofitable

November 5, 2009

Teleconference Handbook

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Companies in Distress
Valuing the Impaired and Currently Unprofitable

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Panelists:
R. James Alerding, CPA/ABV, ASA, CVA
James D. Ewart, CPA/ABV/CFF, CVA
Robert Shortle, MBA, CPA

Please note: This Handbook does not qualify for self study CPE credits.

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Teleconference Panelists Biographies

R. James Alerding, CPA/ABV, ASA, CVA

Mr. Alerding has been actively involved with the valuation of businesses since 1980. In addition to valuing a number of businesses each year, Alerding also lectures frequently on the subject of valuations of closely held businesses, and has produced a number of treatises and several articles on the subject. In 1994, Research Institute of America (RJA) a national publisher of tax and businesses books and materials, published two books written by Mr. Alerding, entitled Purchase or Sale of a Closely Held Business and Valuation of a Closely Held Business. In 1997, RIA released the Second Edition of Valuation of a Closely Held Business authored by Mr. Alerding.

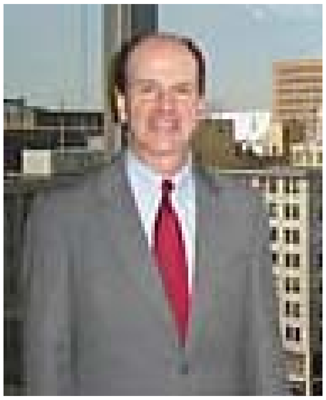
Mr. Alerding has and does perform valuations for many diverse purposes, including purchases or sales of businesses, buy/sell agreements, estate and gift tax matters, bankruptcy proceedings, damage cases, charitable contribution deductions, ESOPS, divorce cases, and other matters. Mr. Alerding has assisted a number of businesses in the sale of the business or assisted buyers in the purchases of businesses. Mr. Alerding has assisted bankruptcy courts in determining the value of a business for purposes of a restructuring, sale to outside parties, or liquidation of the bankruptcy estate as well as accounting and assistance to creditor's committees.

Mr. Alerding's experience in valuation has also resulted in substantial experience on litigation matters relating to business valuation issues, having testified well over two hundred times on such matters. As such, Mr. Alerding is more appropriately suited than most valuators in assisting clients and their counsel in litigation issues that might arise in relation to the valuation. Mr. Alerding is uniquely qualified to back up his valuation with testimony in a court of law if necessary.

Mr. Alerding is Accredited in Business Valuation (ABV) by the American Institute of Certified Public Accountants. He is an Accredited Senior Appraiser (ASA) of the American Society of Appraisers in the discipline of Business Valuation. He is also a Certified Valuation Analyst (CVA) of the National Association of Certified Valuation Analysts. Mr. Alerding is also a Certified Public Accountant (CPA) in the States of Indiana and Maryland.

James D. Ewart, CPA/ABV/CFF, CVA

Jim, a director in the Dixon Hughes' Charleston-East Bay office, is responsible for planning, supervising, scheduling and reviewing of business valuation engagements, managing client relationships, assisting with consulting engagements, staff development and quality assurance related to business valuation engagements. He has extensive experience in valuation of closely-held and/or family owned businesses incident to divorce, succession planning, shareholder dispute resolution, estate & gift tax and transactions. He has assisted clients in the negotiation, structure and closing of acquisitions or sales of closely held business; the valuation of stock options; and ESOP shares He has provided expert testimony in family, state, and district courts. Jim graduated from Newberry College in Newberry, South Carolina with a B.S. in Accounting. He is a former Tax Partner at Coopers & Lybrand/Price WaterhouseCoopers and Managing Member of Ewart & Patz, LLC.



Robert Shortle, CPA, MBA

Mr. Shortle is a co-founder and Senior Managing Director Periculum of Periculum Capital Company, LLC and head of the Firm's investment banking and merger and acquisition practice.

He was previously President of the securities firm, Huntington Capital Corp., which was owned by Huntington Bancshares, Inc. Previous to that he was Sr. Vice President and Managing Director in-charge of the Corporate Finance Group for the securities firm Raffensperger, Hughes & Co. Mr. Shortle has worked as a Manager with KPMG Peat Marwick and as Vice President with Bank One, Indiana, NA, (f/k/a Indiana National Bank), where he founded their corporate finance group.

Mr. Shortle has personally led or managed over a hundred merger and acquisition transactions. He has led or participated in private placement financings for startup companies, growth companies, corporate acquisitions, and turnaround companies as well as public offerings for more mature companies.

He received an MBA in Finance from Indiana University and a BS in Electrical Engineering from the University of Illinois, and is a CPA. He currently serves as a Director of several private companies involved in manufacturing, distribution and financial services.

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Objectives

- Expose attendees to the special issues involved in the valuation of distressed or impaired businesses related to:
  - The differences in distressed and impaired companies and the specific issues that impact the value of such companies
  - Actions that should or can be taken by management to maintain or improve the operations and/or value of a distressed or impaired company
  - The issue of when should consideration be given to the liquidation premise of value

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Defining Value

STANDARDS OF VALUE

- Fair Market Value
- Fair Value (State Rights/Financial Reporting)
- Intrinsic Value
- Investment Value

PREMISES OF VALUE

- Going concern
- Liquidation (Orderly/Forced)

James R. Hitchner, *Financial Valuation: Applications and Models*, 2nd ed. (Hoboken: John Wiley and Sons, Inc., 2006), Ch. 1.

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Definitions: Distressed and Impaired

- Distressed
  - Having been foreclosed and offered for sale, usually at a price below market value*
  - Of, relating to, or experiencing economic decline or difficulty**
- Impaired
  - Functioning poorly or incompetently*
  - Disabled or functionally defective **

* Answer.com online dictionary - http://www.answers.com.
** Merriam-Webster online dictionary - http://www.merriam-webster.com.

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Special Issues in a Distressed or Impaired Company Valuation

- Liquidity
- Contractual defaults (such as bank covenants)
- Greater emphasis on cash flow (as opposed to “earnings”)
- Short term solvency issues – i.e. can the company create “cash flow” in the short term?
  - Stabilizing the company is most important (if that is a reasonable assumption)
- Effects:
  - Asset based lending is likely more available than cash flow lending
  - The liquidation value of the company may become more important than the going concern value

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Additional Considerations

- Outlook for the company
  - Consistent with the industry
  - The ability of current management to keep the company afloat
  - The outlook given a replacement management
- Feasibility of the forecasts and the reasonableness of the assumptions.
- What is the optimal capital structure for the company
  - Perhaps more important – what is the **attainable** capital structure given the stress and impairment of the company.
- Facts and circumstances that led to the distress or impairment.
- What is the permanent loss of business or relationships (e.g. suppliers, etc.) as a result of the impairment, if any.

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Approaches to Value

- **Income Approach** – It is likely that the discounted benefits method will be used as opposed to the capitalization of benefits.
- **Market Approach** – The approach should focus on locating similar, **distressed or impaired**, companies under both the guideline publicly traded company method and the guideline company transaction method
- **Asset Approach** – Very little changes in the application of the asset approach. However, if the premise of value changes midstream from going concern to liquidation value, the determined value of the underlying assets is likely to be affected.

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Consideration of Risk in a Distressed or Impaired Company Valuation

- Domestic Economic Factors Affecting Value
  - Real economic growth
  - Inflation
  - Interest rate risk
  - Default risk
  - Investor risk aversion
  - The risk-free rate into perpetuity?

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Consideration of Risk in a Distressed or Impaired Company Valuation (Continued)

- The Industry
  - Challenging environment across all industries
  - Where is the industry/company in its life cycle
    - Start-up – high failure rates
    - Growth phase
    - Mature
    - Decline – increasing/high failure rates
  - Concentration

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Consideration of Risk in a Distressed or Impaired Company Valuation (Continued)

- The Industry (Continued)
  - Substitute products
  - Threat of new entrants
  - Growth outlook
  - Is the industry cyclical
    - Commodities
    - Housing

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Consideration of Risk in a Distressed or Impaired Company Valuation (Continued)

- The Company
  - Determine the cause(s) of distress or impairment
    - General economic contraction and industry decline (previously discussed)
    - High leverage
    - Bank covenant default
    - Operating inefficiencies/Mismanagement
    - Perceived risk of suppliers and customers

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Consideration of Risk in a Distressed or Impaired Company Valuation (Continued)

- The Company (Continued)
  - Evaluate management's action plan
    - What is the basis for management's assumptions
      - Macroeconomic and industry factors
      - Internal adjustments
    - Are the assumptions reasonable
    - Are the financial projections attainable
    - Does the plan rely on existing assets or growth assets
  - Determine the premise of value (though quite subjective there can be a good case for a unique strategic value if the company were to be sold)

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Premise of Value Considerations

- What is the purpose of the valuation
- Who's judgment is it
  - Clarify the premise of value beforehand
  - Understand the purpose of the valuation

* Aswath Damodaran, *The Dark Side of Valuation: Valuing Young, Distressed, and Complex Businesses*, 2nd ed. (Upper Saddle River: Pearson Education, Inc. 2010), Ch. 3.

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Premise of Value Considerations (Continued)

- At what point does the premise of value change
  - Moving from going concern to liquidation
    - Default risk and projections*
      - Bond ratings
      - Decision Tree Analysis
      - Monte Carlo Simulation
      - Scenario Analysis
      - Altman Z Score
        - No clear strategy to fund either in or out of bankruptcy
        - No identified strategic corporate buyer fit

* Aswath Damodaran, *The Dark Side of Valuation: Valuing Young, Distressed, and Complex Businesses*, 2nd ed. (Upper Saddle River: Pearson Education, Inc. 2010), Ch. 3.

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The Impact of Special Issues on the Valuation Approaches

- Asset approach becomes paramount at least as a fall back value
- Liquidation premise to determine asset values is of the most interest to the owner/buyers/creditors

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The Impact of Special Issues on the Valuation Approaches (Continued)

- The Income approach becomes important as the primary line of value (given the "floor" value of the asset approach).
  - Cash flows are paramount in this approach
  - Historical cash flows are likely of little value
  - A DCF method is the only reasonable income method in this situation
  - Forecasts are critical as assumptions are difficult when valuing a distressed company
  - If the situation allows, consider a "real options" approach to the DCF

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The Impact of Special Issues on the Valuation Approaches (Continued)

- The market approach is of value only if there is a truly comparable market for the target company
  - Query: Is the market comparable if the "market" companies are not distressed?
  - The Guideline company method is difficult in a non-distress situation. Probably not useful in the case of a distressed or impaired company
  - Particular intangible assets might make the company valuable whether impaired or not. In such a case, a market transaction method might be appropriate

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Normalization in a Distressed Valuation

- Standard normalization adjustments
  - Non-recurring items
  - Non-operating assets
  - Accounting method differences

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Normalization in a Distressed Valuation (Continued)

- Additional considerations
  - Normalized revenue
    - Is the company's industry cyclical?
    - Is the industry currently in a trough?
  - Operating costs that can be or are being eliminated
  - Future investments/divestments
  - Restructuring costs
  - Extra legal expense
  - Extra accounting expense
  - Bank covenant violations
  - Cost of refinancing

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Valuing Start-up Companies

- Difficulties
  - Assessing management's capacity to build the business
  - Analyzing the market for the product or service
  - Have limited operating history
  - Operating history likely contains net losses
  - Development of projected cash flows
  - Development of an appropriate discount rate
  - Generally, over 50% of start up businesses fail within five years

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Valuing Start-up Companies (Continued)

- Suggestions
  - Consider macroeconomic and industry factors that would effect the company
    - Are product or service needed
    - How unique is the product or service
    - Industry growth prospects
    - Likelihood of additional competition
    - Future ability to raise capital
  - Forecast at least three to five years into the future
  - Assess the reasonableness of projections and assumptions, both management's and the analyst's
  - Utilize the aforementioned default risk scenario analysis

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Valuing Mature-underperforming and Declining Companies

- Difficulties
  - Calculating the value of mismanagement
    - Poor management of assets
    - Underutilization of strategic advantages
    - Poor investment strategies
      - Overly conservative
      - Overly aggressive
  - Addressing poor revenue growth and fading margins
  - Risk of high or increasing amounts of leverage
  - Development of an appropriate discount rate

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Valuing Mature-underperforming and Declining Companies (Continued)

- Suggestions
  - Assess the reasonableness of projections and assumptions
    - How is a change in management going to affect profitability
  - Determine if the company is planning to expand (with growth assets (higher risk)) or focus on core competencies (with existing assets)
  - Test the reasonableness
  - Conservatively analyze refinance assumptions

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Valuing Mature-underperforming and Declining Companies (Continued)

- Suggestions (Continued)
  - Consider macroeconomic and industry factors that would effect the company such as:
    - Economic growth expectations
    - Industry outlook
    - Likelihood of reduced competition
      - » Consolidation
      - » Industry participant exodus
    - Cost to raise additional capital

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Valuing Cyclical Companies

- Difficulties
  - Overvaluation and undervaluation
    - Many analysts tend to overvalue companies when an industry is thriving and undervalue companies in industry downswings
  - Avoiding missteps
    - Review industry periodicals, historical trends and forecasts
    - Keep in mind that depressed industry growth rates generally return to normal
    - In an industry downswing/upswing, consider the entire business/industry cycle and use average revenue/expenses in the determination of value.

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Discount for Distress?

"Distressed entities generally have higher risk profiles and lower profitability levels compared to their healthy competitors, and a proper discount for distress, usually at least 20%, therefore must be built into the valuation."*

* David Lurvey, Timothy O'Brien, George J. Schultze, Hidden Treasures: Techniques for Valuing Distressed Enterprises, Turnaround Management Association.

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Development of an Appropriate Discount Rate

- Selection of the discount rate

  + Risk-free rate (shorter time horizon)
    - Long-term risk free rate?
    - Match the cash flow with the corresponding risk free rate?
  + ERP
  + Size Premium
  + Default Spread
  + Company Specific Risk

  Risk Adjusted Discount Rate

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Development of Appropriate Multiples

- Broader valuation matrices may make sense such as Enterprise multiples of Revenues, due to fundamental changes that are taking place within the company (selling of assets, line of business contraction or expansion, etc.)
- It is important to search for and analyze comparable firms that are in distress
  - Determine if the reasons for distress are similar
  - Determine if the distress industry wide or company specific
    - Consider looking at multiples over a broader period of time and estimate where the company is at in the economic cycle, i.e., are the trends down, stabilizing or up.

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Orderly Liquidation Value

Asset	Valuation Convention	Items Affecting Valuation/Realization	Current Environment
Cash and Marketable Securities	• Gross book value	• Nature of asset. Cash may be restricted or earmarked for a counterparty	• Lower cash balances with potentially higher float levels than historically
Accounts and Notes Receivable	• Gross book value multiplied by historical collection percentage	• Receivables aging • Customer and industry concentration. Eligible vs. Ineligible from ABL perspective • Customer programs including feasibility of customer returns/credits • Consider costs to collect • In time, most receivables are collected upon, litigation used as a safety valve	• Higher than normal past due concentration due to customer "stretch" • Higher component of receivables from bankrupt or distressed customers, creating incremental likelihood of write-of

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Orderly Liquidation Value (Continued)

Asset	Valuation Convention	Items Affecting Valuation/Realization	Current Environment
Inventory	• Recent appraisals with adjustments made for current gross inventory position (amt./type/status)	• Seasonality (high vs. low selling season) • Cost-benefit analysis for in-process inventory completion • Existing orders against specific inventory • Advanced payments against inventory, which may dilute recoveries	• Deeper discounts as a result of: – Lower ordinary course volumes and margins – Excess inventory in current channels (perhaps from similar liquidations)
Prepaid Expenses	• Net book value with a factor applied depending on the determined collection prospects	• Costs to dispose • Litigation may be used as a safety valve	• Dependant on specific case

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Orderly Liquidation Value (Continued)

Asset	Valuation Convention	Items Affecting Valuation/Realization	Current Environment
Intangible Assets / Intellectual Property	• Recent appraisals, or if unavailable, management input/valuation discretion	• Proprietary nature of products/services • Patents / trademarks / copyrights held and associated terms • Potential future cash flow from assets	• Generally lower appetite for intangibles, if any to begin with
Property, Plant & Equipment	• Recent appraisals • If appraisals are unavailable, analysis may be used taking account book values and/or original cost multiplied by factor	• Standard characteristics (size, location, age) • Utility or transferability of assets across products/industry • Costs to dispose	• Unprecedented value deterioration due to reduced demand, significant supply (from similar liquidations), limited financing options • Significantly longer marketing period. In some cases 2+ years

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Always Consider

- What is the condition of the industry in which the company participates?
- How much of a company's distress is related to mismanagement?
- Does the business have access to capital?
- Has risk been appropriately accounted for?
  - Projected cash flow
  - The discount rate
  - Both (be careful not to double count)
- Have valuation multiples been developed using comparable companies?
- What Is the probability of bankruptcy?

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Companies in Distress: Valuing the Impaired and Currently Unprofitable
Business Valuation Resources
November 5, 2009/10:00 a.m. PT

Blake Lyman: Hello and welcome to *Companies in Distress: Valuing the Impaired and Currently Unprofitable*, a BVR teleconference featuring Jim Alerding, Jim Ewart, and Bob Shortle. I'm Blake Lyman, Professional Program Manager for BVR.

In today's presentation, we turn our attention to the largest consequence of the recession on the valuation of a business, the coming wave of distressed businesses requiring valuation. Over the next 100 minutes, our expert panel will cover both how the economy has created this unprecedented spike in valuations of impaired companies and to develop the tools necessary to adequately and properly account for valuation of these companies.

Our moderator today is Jim Alerding who has been actively involved with the valuation of businesses since 1980 and is also a frequent lecturer on the subject of valuations and closely held businesses and is the author of a number of treaties and articles on the subject. He is also the author of *Purchase or Sale of a Closely Held Business* and *Valuation of a Closely Held Business*.

Jim Ewart is a director in Dixon Hughes Charleston-East Bay office. He has extensive experience in valuation of closely held and/or family owned businesses incident to divorce, succession planning, shareholder dispute resolution, estate and gift tax, and transactions. He has assisted clients in the negotiation, structure and closing of acquisitions or sales of closely held businesses, the valuation of stock options, and ESOP shares.

Bob Shortle is co-founder and Senior Managing Director of Periculum Capital Management and head of the firm's investment banking and merger and acquisition practice. Mr. Shortle has personally led or managed over a hundred merger and acquisition transactions and has led or participated in private placement financings for start-up companies, growth companies, corporate acquisitions, and turnaround companies as well as public offerings for mature companies.

We are thrilled to have Jim, Jim, and Bob join us today, and you can read much more about them on the web page for today's conference.

We'd also like to thank the CICBV for their support today as co-presenters.

But before we get going, I'd like to remind you that in order to receive the two CPE credits available, you must complete and submit a brief survey at the conclusion of today's presentation. A link to that survey was included with your registration email, which included instructions on how to dial in today, and is also available on the reading page for today's teleconference. The survey will be active for five business days and will require you to fill in three four-digit CPE codes. Please write down the codes as they're read and fill them in when asked in the survey. We'll process our surveys between five and ten business days after the conference and we'll issue your CPE certificate via email.

I'll read the CPE codes three times during today's conference – one hour through the presentation, at the conclusion of the presentation, and right now. The three four-digit CPE codes are 5543, 3146, and 2910. Once again, that's 5543, 3146, and 2910.

We will be taking questions during the session by email only. Please send questions to *tc-questions@bvresources.com* – once again, *tc-questions@bvresources.com*. That email address is at the bottom of every slide in today's presentation.

And with that, we turn to Jim Alerding, Jim Ewart, and Bob Shortle.

Jim Alerding: Good morning or good afternoon wherever it is that you might be. This is Jim Alerding and I'm also very excited to be with you today. I think we've got a great panel of experts to go through this subject and I believe that we've put some information together that I think will be very helpful to each of you, each of the participants on valuing distressed and impaired businesses. Hopefully we're going to have some information for you that will be kind of a new way at looking at this because there is a lot out there in the marketplace since this economic situation has occurred. But as I said, hopefully there will be a lot of new information that you will be able to pick up as we go through this.

Blake, could you go on to the first couple of slides here? And that's just the Circular Notice.

The objectives that we have today are to expose each of you to the special issues that we believe are involved in the valuation of distressed or impaired businesses relating to the differences in distressed and impaired companies and the specific issues that impact the value of each of those types of companies; actions that should or can be taken by management to maintain or improve the operations or the value of a distressed or impaired company; and the issue of when should consideration be given to the liquidation premise of value, which, in today's world, is a very important factor to consider.

We're also going to look at emerging companies or start-up companies a little bit and look at some of the issues that are related to this distressed or impaired concept.

Okay, Blake.

So first of all, we're going to do a little obvious review here for all of you. The major standards of value that are out there in the marketplace are fair market value, fair value, state rights and financial reporting, intrinsic value, and investment value.

Now the premises of value include going concern and liquidation premises of value with orderly or forced liquidation premises.

You're going to see that some of these are appropriate in looking at distressed or impaired businesses and some of them are not. But I would highlight again that I think the liquidation premise of value is going to be one that we are going to have to look at more frequently and more often in today's world.

Let me throw the mike over to Jim Ewart to talk a little bit to us about some of the definitions of distressed or impaired businesses that we'll be talking about today. Jim?

Jim Ewart: Thanks, Jim, and I guess continuing with the saga, definitions, at least, the dictionary defines distressed as having been foreclosed and offered to sale usually at a price below market.

Impaired is defined as functioning poorly or incompetently.

Obviously, there's a fine line between these two definitions, but both of these suggest that any company meeting these definitions will require some sort of financial restructuring, and financial restructuring would include bankruptcy filings and it may introduce new or different players into the capital structure than what had been there prior to this time.

As we've seen with Wall Street, we had the federal government get involved, which is clearly a new player into that marketplace.

As far as the companies are concerned, there may be new capital partners that are introduced. These would include hard money lenders. Those are lenders that typically have interest rates that pick up a little bit, but they're looking for hard assets upon which to loan against. Examples of those would be the Foothill Division of Wells Fargo and Heller Financial, which is part of GE Capital.

Debtor-in-possession financing also gets introduced into these types of companies, and those are either existing creditors or potential buyers that will provide asset-based lending or buyers of the distressed debt, that is the debt that's already on the books or in place. It comes into play either through a bank failure or through banks trying to shore up their capital base and putting those out into the market. The buyers of that kind of debt are trying to leverage up their position. So it could be that there's an equity play that gets introduced as part of the debt side of things.

Jim Alerding: Let me also interject here since we're kind of on definitions, but even though the focus and probably why many of you are on the line today is because of the situation that the economy has brought about, but as you'll see as we go through this, even in the best of times, there are distressed and impaired businesses and they could have multiple causes, one of which that we'll talk about would be causes created by improper or poor management. So that's something to keep in mind also.

Do you want to go on to the next one, Jim?

Jim Ewart: Well, yeah, what I think we have to keep in mind is that the landscape has changed and that the effects of management's decisions now have both short-term and long-term effects that we've got to keep focused on.

Jim Alerding: Okay, Blake? Jim?

Bob Shortle: This is Bob.

Jim Alerding: Okay, Bob?

Bob Shortle: Okay, we're focusing now on the additional considerations as you get into these situations as the investment banker in the group who's actively involved in selling companies and financing companies. These are kind of how I look at these issues because still valuation drives everything I do.

As I look at the company and the outlook for the company, I'm very focused on where it fits in the industry. Is it doing as well as, or doing the same as, or doing better or worse than the industry itself? This obviously has a big factor on when you look at trying to find comparables to attempt to value these.

I spend a lot of time looking at the ability of management to keep the company afloat. Can they get through this? This is probably one of the big dividing lines between whether it's going to be a going concern valuation or going concern sale, or is it going to be a liquidation situation.

Jim Alerding: Let me interrupt a minute. Blake, could you go on one more slide? We'll actually come back to that other one there. All right, wait a minute. Go back. I'm sorry. You had it – you had it correct. All right, go ahead. Go ahead, Bob, sorry.

Bob Shortle: Okay, no problem. Sometimes you have situations where you look at the company's not doing well and you think about what if we replace management. We find these situations very frequently where you kind of have a good business but not necessarily the right management. The one thing I've noticed over the years as the company grows and so forth, a lot of times the opportunity outgrows the management team and a lot of times they get in trouble as a result. So when you're looking at it from what's the value, look past maybe existing management and what it could be.

Obviously, anybody getting involved in valuation scenarios, it needs goods forecasts and it needs to determine the reasonableness of the valuation. And we spend a lot of time, even as investment bankers, really coming to grips with that, and it's probably more important now than ever in these more distressed times.

We're also looking at the optimal capital structure for the company. One thing we've seen a lot out of last year is that so many companies have lost money and they may have had maybe a 50/50 split between debt and equity. With the losses they've sustained, there now may be 90 percent debt. So as you look at that and try to figure out the value, you might make some case that you've got a lower cost of capital. So that's not logical in terms of figuring out what it's really going to be worth in any sense, in a sale or financing. So you've got to really focus on what would be a more realistic capital structure and can you achieve that capital structure.

Finally, we do take a hard look at figuring out why did they get in this problem in the first place, understanding what caused the distress, how did it get here, and then finally is it permanent or are they going to be able to get through this. Obviously, if it's something you can get through, that has a much, much different outcome than if you can't get through it.

Sometimes when we're looking at these businesses, we're saying now we really may have a smaller business coming out of this current economic stress, and you need to look at it not what it was but what it will be after they get through this problem.

Jim Alerding: And I think I would add to this that going back to the feasibility of the forecasts and the reasonableness of the assumptions, I think during the good times, we tend, as valuation experts, to be not so attentive to those assumptions, and it's really critical in this time in the things that Bob talked about that are in the remainder of this slide. But in every sense, what are the assumptions that go into those forecasts? And you need to be challenging those. What's happened to the customer base, for example, with this permanent loss of business? If there was a concentration of customers to begin with, there could be issues. You'll see later as we go through this, the industry could cause issues. There are all sorts of things. But you really have to be attentive to those forecasts. And I think you're also going to see that you're going to have to rely more on forecasts and less on history as we go forward.

Next slide, Blake, please.

Now again, we're just going to review here the approaches to value. Of course, there's the income approach. It's likely that the discounted benefits method, as I just mentioned, will be used in the case of a distressed or impaired company as opposed to the capitalization of benefits, and again, that's because the history is likely to be of little value and little use in the case of a distressed or impaired company, because if it is distressed or impaired, the historical situation is likely to be in it during a time where it was not and it's likely not to be reflective of the future. It may be helpful in some ways but probably not something you can hang your hat on.

The market approach for a distressed or impaired company should focus on locating similar companies if you're going to use it at all, in other words, other distressed or impaired companies. So you may be scratching your head saying, "Well, how the heck do I do that?" And that's a valid question. There may not be good answers to that. If you are someone who likes to use the transaction databases to determine a value, you have to understand it's likely that the companies in that database either are not distressed or impaired or you're going to have a difficult time telling which ones were.

Jim Ewart: Jim, excuse me for interrupting, I think it's going to be very difficult to use the transaction databases against the distressed company to even begin to adjust for the multiples that you may be getting out of those.

Jim Alerding: I agree and I think we'll see as we go on that Bob's going to have some good thoughts, I think, on the multiples that are out there and what he's seeing in the real marketplace. And Bob, you might want to give us a quick comment on that right now.

Bob Shortle: Yeah, in my world, the investment banking side where we're faced with selling companies and trying to bring a business case, we still do use those. But I guess you'd have to say we get down to making some very significant interpretations or judgments about what is relevant today based upon all the factors that have affected the business and that have affected the economy. And I think it does become much more subjective, it becomes much more difficult probably to build your case in a nice tight way on valuation.

And again, using the income approach, you have a much easier case, I think, to build with.

But still I would say from our standpoint, the market approach, though it does not apply easily, is still a big factor, and I have one particular deal I'll walk you through later that will highlight that.

Jim Alerding: Okay, so I agree with both Jim and Bob on this, that likely you're not going to use the market approach and for sure you're not going to use the transaction database.

Quickly on the guideline method, the stock market, as you know, is so volatile. It's up 200 one day, down 200 the next day, and then it will meander for a while. And the problem is that first of all, the public market is not a good guide for distressed or impaired companies to begin with, but then place the volatility that's in there right now alongside of that and I don't think you can get a good answer.

The asset approach is now becoming more of a focus. In looking at a distressed or impaired company, there are few changes in the application of that approach, but the premise of value may change midstream, midstream in your valuation picture, from going concern to liquidation value. And I keep coming back to this, that the determined value of the underlying assets is likely to be affected by that shift from going concern to liquidation. And I think again, in talking to Bob Shortle about putting this conference together, the lenders and even the equity investors are going to be more concerned about what's the liquidation value of this company, what is it I'm actually going to get back in cash if I have to go to the extreme, if I put my money in this.

Go ahead, Jim, you have something to say.

Jim Ewart: Yeah, there's a question that came in on when using the liquidation premise, what effect, if any, does a plan of liquidation have on the applicability of using this premise. Many courts then shy away from accepting this premise if a company or its management has not adopted or is in the process of adopting a plan of liquidation.

Jim Alerding: I think that's speaking somewhat to what you were just talking about there, Jim, in the sense that –

Jim Ewart: If we're looking at the asset approach and then we are looking at a liquidation premise of value, then the question becomes whether it's orderly or forced, and those are, as we know, two different values.

Jim Alerding: Yeah, I think too that if there's a plan of liquidation, if I understand the question here, that may actually put us over the top into more of a bankruptcy setting or just a complete liquidation. And so what effect does that plan have on the applicability of that premise, I think –

Jim Ewart: Well, going concern is certainly out the door, right?

Jim Alerding: Well, yeah, I would say it depends like on a lot of things. You can have a situation where you can still have a plan of liquidation but you can have a viable operating business. It just may have too much debt. So once again, you've got to look at the facts and circumstances of the situation to really get that answer.

Okay, Bob?

Bob Shortle: Looking at again the domestic consideration you need to look at today, I guess the first statement, obviously, everything right now is just [inaudible] like everybody's alluded to.

On the real economic growth side of what we're seeing is – and this has been a very severe downturn – my experience has generally been a lot of times you get a pretty quick turnaround. I don't see that time. I see a much slower recovery. So looking at projections, if somebody sees a quick rebound, I would be highly questioning that whether that's really possible.

I think inflation over the next several years will be pretty low. I don't see it as a big issue. But three and five years out, I think it's significant, and obviously, if you're looking at each, it could be significant, so looking at situations on how that could impact profitability and the business in general.

When you get into looking at interest rates today and the impact of this environment, I think everything about cost of capital probably has gone up. What I've seen in interest rate situations, if any bank deal, for example, has to be redone, almost every time the rate is going up. The banks are finding any excuse they can to raise rates.

However, with our low LIBOR costs today, you are also seeing them putting in floors because the LIBOR is so low that the banks are just unwilling to lend on some incremental interest rate above LIBOR.

Obviously, default risk in so many situations needs to be addressed because sometimes I think maybe half the companies in the United States have defaulted in their bank at some level. So I think you have to be looking at that and focusing on it.

On investor risk aversion, in the current period again, there are fewer investors. There's no question. They want a better deal as a result as cost of capital is up. So whether you're looking at interest rate issues or just investor cost of capital, it's all going up at some level.

Jim Alerding: And if I can jump in here for a second too, the BVWire, for those of you who get it, actually came out yesterday with a Pepperdine Private Cost of Capital Survey and it had some information directly on that point where the rates that are going to be required by the investors at the different levels – venture capital, private equity, mezzanine, and banks, et cetera – and they are all going to be higher than they've likely been in the good times.

Bob Shortle: One of the interesting things is that final point on risk-free rate into perpetuity. It's not something I normally worry about a lot myself but I will say the thing that is so unique right now has been such a government effort to create liquidity in the market. Again, it's created very low short-term rates and even long-term rates because of the massive amount of money that the government has put out there. But at the same time, the U.S. currency has still been strong so it's been a flight to our securities, whether it's short-term or long-term bonds.

So to me, you have currently, when you're looking at the risk-free rate of return, an unsustainable situation. So I think as you approach valuation in this time, personally, I think you've got to look over a longer period of time and look over and not focus just on short-term interest rates associated with current cost of capital or long-term bonds themselves.

Jim Ewart: Yeah, Bob, I would echo that and I think there are some out in the marketplace. I believe some of the stall words are out suggesting that the risk-free rate in a build-up ought to be somewhere in the neighborhood of 6 percent.

Jim Alerding: We've got another good question here. It is determined that an asset-based methodology is best suited. Would you request outside appraisals for M&E, inventory, real estate, et cetera be performed on both premises – that is, going concern and liquidation? If so – which we assume you will – would you present within your report both values determined under each premise or would you simply conclude on one, disregard the other and proceed? Excellent question.

To answer the first one, you're right. I at least personally do agree. I would have outside appraisals done if those assets were material to the business, which, in many cases, if you're going to a liquidation premise, they would be material. Yes, I would have outside appraisals done and yes, I would likely have them done on both a going concern and liquidation basis but not always. And in the case of a distressed or impaired business, I might lean more heavily towards the liquidation premise. And so as it relates to a value in a report, again, I may have both or I may just have one of the two premises and it may depend a lot on what the purpose of the valuation is and what the exact status of the company is.

Jim, do you have any thoughts on that?

Jim Ewart: Well, yeah, Jim, I think I would echo that, that I think what would drive that ship for me would be what's the purpose of the valuation, why am I being retained to start with.

If it's the equity holders, I might take a little different approach in that I may show the primary, the going concern value, and then maybe footnote or have exhibits showing what the liquidation value might be.

If it's the lenders that are retained, then I think it's a totally different situation there and I think we're more in line with what you were just saying.

Jim Alerding: Bob, do you have any thoughts on that?

Bob Shortle: Nothing additional to add.

Jim Alerding: Okay. Let's go ahead on to the next slide. Jim?

Jim Ewart: The industry focus here is certainly important and is certainly worthy of review, and depending on the industry in these times, it's going to have certainly more impact than others, which are rather obvious statements.

To me, what I think is far more important is the company itself and where's the concentration of risk. Is it in the supplier base? Is it in the customer base? Is it in the workforce? Really having an understanding of the company and then how it relates to the industry and then how the industry's been impacted by this is certainly the task at hand.

If we could go on to the next slide.

So we really can't ignore the traditional questions or understanding of what we would normally get into, which are the substitute products and the new entrants and what's our growth outlook and those things.

And there are helpful sources for that information that we use. IBISWorld has good write-outs, First Research, Capital IQ, certainly trade journals. But I think what's really driving the ship at this point in time is how has the industry been impacted, and we can get that from those sources and certainly the trade publications, but really focusing in on the company that we're looking at and how has it been impacted, and more importantly, how is it responding to those effects, and just really focusing in on those three basic components – the supplier, the customer, and the workforce.

Jim Alerding: I think another thing to look at in this industry situation, maybe different from what we've done in the past, is we ought to look around more to talk to some people that are actually in some of these industries and get some more relevant information as to what is going on.

For example, in the commercial real estate industry right now, banks are what I call in a negative lending position. I mean I'm dealing with several projects today where the banks are just simply calling in everything and saying, "Go find another bank." Well, you can't find another one because they're not lending either. They're pulling their loans back. So I mean that's a severe impact on an industry that's caused by another industry and I think you've got to look at it in all of those situations in a particular industry that your business may be in.

Jim Ewart: Yeah, and I think that's happening not only in the commercial real estate, Jim, but also certainly in the smaller companies where lines of credit are not being extended or renewed. If they are, the interest rates, they're forcing up a higher rate, one, and two, they're requiring more investment in order to continue lines.

So there's, to me, just a multiple negative that is impacting these companies that are forcing them to make them some very hard decisions in order to survive that obviously then ultimately affects values.

Bob Shortle: I would like to also reemphasize too that issue, that you're making contact with other people in the industry. If I have to say in my own business, if we've ever made errors or mistakes, probably the most consistent issue has been is we didn't know enough about what was going on in that industry. When you have a distressed environment, the importance of this just is greatly increased. It can cover almost anything but there could be things going on in the industry that could destroy value very easily or something that could be very positive. But looking just at your client company, I think a lot of times you may not see any of what's really going on. So I think the contacts in the outside industry can be very important.

Jim Alerding: One of the sources we've used for as long as I've been in this valuation area is a trade association and there are thousands of trade associations out there and they're easy to find online and don't hesitate to call them up. They're usually very friendly and they love to talk about their industry and they can give you, either they directly can give you a lot of information on what's going on in the industry, or they can say, "Well, call Joe Smith down the street here and Joe can tell you a lot about what's going on in this industry."

To echo to Jim and Bob, I mean it is so critically important, particularly in the case of a distressed or impaired business, to know a lot about the industry. As Professor Harold Hill said in the Music Man, "You've got to know the territory," and you really do have to know the territory.

Okay, Bob?

Bob Shortle: Now looking at some of the particular risk issues in the company itself, obviously, the first one we've listed here, general economic contraction, we've kind of covered before, but kind of spinning in a different direction.

One thing we have seen ourselves is there's been so much in the last decade, efforts by companies to reduce the number of vendors and we see it in all kinds of industries. Probably the most notable is in automotive.

In many cases, there are fewer companies making a part. It goes to somebody else. And so in some cases, this economic contraction could be doing further weeding out. And you may have a client that actually has more value today because they have the ability to survive when many of their competitors may actually go out of business.

So it's obvious to look at the negative on general economic conditions but there can be positive scenarios to work with.

On leverage, again, it's an obvious problem today. Again, we've all talked about the banks that are more difficult than they were to deal with in the past.

I think it's actually interesting to sometimes find out who the bank is. When you combine that with the issue of bank default, I mean typically, when these banks create their covenants in loan arrangements, one assumption they put in there, one covenant is that you'll actually make a little money every year, you won't go down. If you lose money, you've blown a covenant.

If you've got a bad bank, that could be a real problem and it may be difficult to work through that.

In our market here, a bank that now has been sold called National City, it could have been very difficult to review a deal even though the company might have still been strong.

If you were JP Morgan in our market, which again has been a very strong bank, you could work through it even though scenarios had a big impact on realistically what value this company could have as a going concern.

Operating efficiencies and mismanagement, obviously, these are logical things to see and analyzed in every company.

One of the things that I've been kind of fascinated by as companies released their earnings in the last few weeks, overall, a lot of our public companies have done pretty well. The revenues may have been down materially. Earnings had held up or were actually up.

So I think looking at our smaller client companies trying to figure out can they manage through this, I have several that I've dealt with that are doing well, but I think understanding why it went down and how correctable that is.

I think analyzing the risk of suppliers and customers is critical. I think we've already alluded to that before, mentioning the automotive industry where we see a lot of companies in our geography. In many cases, you might see a supplier who won't be able to supply your client or you may find one that just doesn't want to supply your client. On the other side, you may have a customer that may not be able to pay if you ship to them and that actual customer may not be around.

So I think it's probably more than any time I've been through, taking a hard look at the supplier base and a hard look at the customer base is critical to really determine again the ability to be a going concern.

Jim Ewart: Bob, also in my marketplace, which is the Southeast, we tend to have smaller companies and not maybe as large or diversified as other places that folks may have.

What we are experiencing somewhat is that the ownership doesn't have the ability to point the finger because they typically tend to be management and who is in charge.

What we are seeing though is a willingness and an openness that I haven't seen in my entire career for change, that they are embracing thoughts and ideas on how to do things maybe differently, particularly if those can equate to and be dollarized into efficiencies and increased profit.

Jim Alerding: The other thing I might add, and Bob, I'd like to get your thought on this too, is that the more valuations I do, the more I'm always amazed at unique lenders that show up, and a lot of times they're industry-specific lenders. And I think that's another thing to maybe take into account when you're looking at a business, is, even though the credit markets are tight, what's the opportunity, if any, for a unique lender to come into a particular industry and provide some loan capital or even some equity quasi-loan capital.

Have you run into that, Bob?

Bob Shortle: Oh, absolutely. I think the one thing I will tell you though, this particular downturn, again, has been so different than what I've experienced in the past. A lot of times in our market again, two players that typically love this kind of environment are CIT and GE. They're very big players in our geography in providing asset-based structures and will work in troubled companies, in dip situations, and so forth. CIT obviously has had a big problem. They're bankrupt and they've obviously really cut back. Maybe when they get out of bankruptcy, they may be back. GE, we've also noticed, at least for some time, they've pretty much withdrawn from the market.

There are again though a variety of narrower lenders.

But I think the one thing we have noticed the most in the kind of things we are doing today in our firm is sourcing banks all over the United States. We used to focus pretty much on our geography. Today we're going national for even some relatively small credits.

Jim Alerding: That's a good point, and of course, the banks continue to consolidate and merge as more banks fail and just as the system itself contracts though so that you almost have to do that in a lot of cases.

Yeah, if you'd move on to the next slide, Blake.

Let me go back too because we're going to talk about some other issues here and I want to revisit a question, and this was the one dealing with the plan of liquidation and liquidation premise. And the questioner wants to know what the real issue is, what to do when the courts do not want to consider liquidation premise without a plan or intention on behalf of the subject company to liquidate. As an appraiser, you have determined that the liquidation premise would apply. Now how would you handle the court's mindset especially in light of the current economic conditions? Somewhat of a potential Catch 22 scenario.

Well, I would use, first of all, the old concept that in retail, there were only certain people that could mark down the price of a product, and years ago, they had a green pen. So we used to always say, "Unless you're the guy with the green marking pen, you have no control over the situation." And so the judge in this case is the guy with the green marking pen. And so to some extent, you are at the mercy of whatever a judge believes. That's what the judge's job is.

However, if I were in a litigation setting like this, I would appeal to the fact that my opinion is based on sound principles of valuation and point those out to him. And there's plenty to show that in valuing any business, you do have to consider the premise, and if the premise appropriately is liquidation, that's about the best you can do, is to just say to the judge, "Judge, I'm applying this in my opinion. I'm here because I'm an expert, you've asked for my opinion, and this is what I believe is the most appropriate value."

Jim, do you have anything to add on that?

Jim Ewart: Yeah, Jim, if this is in a divorce setting or a family law setting, it could very well be that the approach that might be helpful would be to address the drain on the marital assets if the business that's been concluded is better off with a premise of value of liquidation, that if it continued in operation, what the drain on the marital asset base would be to get the court's attention as to why this makes sense.

Jim Alerding: Good point. Well, let's continue on with consideration of risk in a distressed or impaired company. We want to carefully evaluate management's plan of action and this is similar to what we talked about briefly before on looking at the reasonableness of the forecast, but it's more than that. It's determining what's the basis for management's assumption, what are their macroeconomic and the industry factors, what internal adjustments are they making.

I'm finding myself in this economy when I'm valuing a business looking more and more at getting more definitive input for management, more than I probably ever have in the past, because they're the ones that are sitting there on the firing line. That doesn't mean that I'm taking their word verbatim as to what they're telling me because depending on the nature of the valuation, they could have a particular bias and their own view.

So you've got to look through glasses that are going to filter out the bias.

But they oftentimes have some great information, and as I said, they're the ones that get up every day, get showered, eat their breakfast, put their clothes on, and head out to the office, so they should know what's going on.

So are their assumptions reasonable, however? Again, filtering out that bias, and sometimes it's just that they're not looking at things maybe correctly themselves but it makes for a good dialogue to talk to them and see what assumptions or what reasonableness they have behind their assumptions.

Are the financial projections attainable is just so critical in today's situation with a distressed or impaired company. It's really looking at these definitively and saying, "How attainable are these?"

I've got a situation right now where I've got a customer base of one for a client and that customer has over 90 percent of the business. So how do I look at that? How do I adjust that? Because the financial projections are almost solely dependent upon the one customer and whether that customer stays with the business – it's a cancelable contract – and whether that customer, in fact, is able to achieve its financial results. So that's an extreme issue but I mean that's the kind of thing that you have to look at in today's economy that you may not have had to look at so much in the past.

In this particular case that I'm dealing with, it was a business and a company that was high flying, and during the good times, you would say, "Well, that company is going to do this well for at least another 20 to 30 years." I'm talking about the customer company now. And in fact, the economy destroyed the customer's business.

And so the reality is – how do you take that risk into account? Does the plan rely on existing assets or growth assets? You've heard both Bob and Jim talk about the difficulty of finding financing.

So if the plan relies on growing the assets of the business, that may be a significant problem because normally when you grow the assets of the business, you've got to find equity and debt unless you're going to internally grow it and that's going to be really difficult in a situation where you already have a distressed or impaired company.

And again, you've got to determine the premise of value, and again, it is quite subjective, though there can be a good case for a unique strategic value if the company was to be sold. And Bob, why don't you talk about that a little bit?

Bob Shortle: Yeah, one thing that we have in our business, we do occasionally deal with a fair bit of early stage companies that may not have one dollar of sales yet. We have one scenario right now we're dealing with. It's kind of impacted by the current activities in Washington related to health care. The company has no revenues. It's completed FDA approval. We have buyers who want to do it but the buyers are reluctant to proceed because they don't know what reimbursement will be once the folks in Washington figure that out. The company needs money to stay alive. And so how do you value that situation? Well, the key is it has the technology and there's clearly strategic value with the buyers of the business.

So if you looked at it, you look at a business that has no revenue, no sales people, no nothing, but it does have unique value and it really doesn't even have a going concern because it's a value of those assets and the people around that unique technology.

We see this in all kinds of situations. One we had a going concern. We were selling a company that was quite troubled. And when we got into it, though it had a unique market position, one of the things we found is we had to spend most of our time initially trying to keep the bank from foreclosing.

But the company was a large fabricator of metal products and they had a lot of welders in the company. And in that particular geography – it was not here in Indiana – but in that geography, welders weren't very hard to find, and so you had a large supply of them making product that was at least similarly related to what the buyer was interested in and they saw a lot of value in that. And so it was a company that had been losing money for four or five years and that had substantial negative net worth. And we sold it for probably two or three times what the debt was and we actually got a fair bit of money returned to the owners.

Jim Alerding: Great.

Bob Shortle: So it's very difficult. I mean we see a lot of situations. We're figuring out what the value is and what the right premise should be as a continued kind of effort on our part to sort that out.

Jim Alerding: Very good. Jim, do you have anything to add to that?

Jim Ewart: Well, I was going to say we're going to cover in a little bit some of those aspects of the intangible value and what's on the balance sheet and what's the rate of return attached to that. And I think what Bob's talking about is a situation where you've got, in its present format, an under-performing asset – in this case, the enterprise – that needed fixing through a change in management that was going to enhance value, it sounds like.

Jim Alerding: Okay, let's move on to the next slide. So again, still on this issue of premise because I think you can see from the tenor of our presentation that the premise is really, really important where in the past we may not have really looked at the premise of value quite much at all, but it is important in this day and age.

So it's also important in determining what the purpose of the valuation is. If we have a purpose in the valuation where the standard of value is investment value, for example, as opposed to the fair market value, even in a distressed or impaired business, the liquidation premise may still not be appropriate for the investment value. You may still have a going concern premise because the purpose and nature of your valuation would dictate that that's the case.

Whose judgment is it on the premise? And that kind of goes back to the question that we've answered previously too about the judge and whether they would accept that. You need to clarify the premise of value beforehand, and again, in order to do that, you've got to understand the purpose of the valuation and that's what really becomes important in looking at the premise of value.

Blake?

Bob, let's pitch it to you now and talk a little bit about at what point does the premise of value change – in other words, moving from going concern to litigation.

Bob Shortle: From going concern to liquidation?

Jim Alerding: Yeah.

Bob Shortle: The key thing, we started out here obviously, there are a lot of tools on which you can kind of analyze the company to make some determination of its probability of failure or demise. And these are obviously all individually and can be very helpful and productive in trying to make that determination, but it's a very important determination to make – there's no question.

Once we have determined in our own mind that we think there are significant issues and risks that it might not survive, our first big focus is – is there any strategy to fund either the company in or out of bankruptcy? Is that even probable? I think the smaller the company, the less likely that will work properly, particularly getting some company through bankruptcy.

As I mentioned before, as we went into this down cycle, we had so many of the major lenders providing DIP financing where we're used to doing aggressive ABL fields that were in trouble. And so that part of the market actually changed more than I've ever seen it. A lot of DIP lenders were not available so the ability to get through bankruptcy was less.

The one thing we did note was that there were a lot of private equity type players interested in buying debt and they wanted to come in and they ended up providing debt as opposed to the traditional asset-based lenders.

But anyway, in going into this, you've got to make that determination. Once you've determined the probability of failure is there, is there a strategy to fund this thing? If there is not, obviously, we're probably focusing on liquidation.

The second thing we also look at, as we've kind of alluded to before, is there any logical strategic corporate buyer fit for this company. Can that be done even though the company looks so bad and has so many problems? Is that likely and likely in a timeframe that could work?

So obviously in those cases where it's going to be a protracted effort and maybe many of the logical buyers are also having distress, then that probably won't play out in a satisfactory way. But if there are logical strong players, many of which you may contacting.

One thing I've noticed is that there is still a lot of M&A activity going on but most of it has been strategic buyers buying up parts of their industry, buying smaller players, consolidating, and so forth, and that's where I have seen most of the activity today.

So anyway, these are how we sort through once we have identified that there's a good chance this company won't survive.

Jim Alerding: Excellent.

Jim Ewart: I think there's a recent article that I believe is in the BVUpdate that addresses the bankruptcy prediction models and I think it's a study done by Morningstar that would be worth taking a look at.

Jim Alerding: And Jim, why don't you go ahead and flesh out a little bit more on what's on the slide up there too on this premise of value change?

Jim Ewart: If we go to the next slide, Blake, we started to talk about this just a little bit earlier when we were looking at the asset approach.

Historically, I particularly have used the asset approach in valuing FLPs and family LLCs. And when we're looking at operating companies, it's only been in the last couple of years, frankly, where we started to notice that certain of the assets may be under-performing better than affecting the cash flow stream that has an effect on then driving value of the business down.

And in some cases, we've seen where the underlying value of the assets, particularly if there's a heavy concentration in certain types of plants, which would be cranes, heavy equipment, those kinds of things, and real estate that is on the books of the company, that the underlying value of the company may be better or higher if the company was bifurcated – that is, split apart, almost like an RJR type of situation.

So the asset approach from our little neck of the woods down here in the Southeast had an increased focus on looking at the underlying assets.

Also, if we've got more than one segment within a business and the assets with one of the segments are not performing as great as the other segment – so for example, let's assume we had Segments A and B. Then we had cash flow of 100 for A and 10 for B for a total of 110 for the company. Our risk rate on each of those might be 20 and 30 for an overall, say, 25. But the underlying value of A would be 500 but the overall value of the company would be only 400 in change.

So really what I'm suggesting here is that we really need to again peel the onion back more so than ever to understand exactly the nature of the business, the assets that are generating the cash flow, what's the rate of return on those assets, and then try to ascertain whether or not the income statement or cash flow stream, which we're valuing in total, may have components to it that would better capture the goodwill component or the intangible value of one segment versus another – or which could also then lead to maybe a bifurcation of the business where there is a discontinuance of a business segment so that the more profitable segment could continue.

And I guess part of what our work is, Jim and Bob, it's not only the valuation side, but I think we can also be helpful to management, particularly closely held, when we make these kinds of observations that could enhance the value to them depending on the nature of why we're in there to start with to do the valuation.

But there are opportunities beyond just valuation, I guess, is what I'm also trying to state.

Jim Alerding: I would agree. I just referred a unique lender to one this morning. It was a valuation client and I think we were able to be helpful in that regard.

Let's move along.

The income approach, as we said earlier in the presentation, becomes important as the primary line of value, and again, given the "floor" value of the asset approach that Jim just talked about.

The income approach as opposed to the market approach is kind of the focus here. And we talked briefly about some of the problems in the market approach and we're going to get into that even more deeply a little bit later.

But the cash flows are going to be paramount in this approach.

I've taught business valuation principles for 25 years probably and I always start out, particularly when I've got some people that really aren't familiar with BV at all, and I always tell them, "Here's Alerding's three principles of valuation. Cash is king, cash is king, and cash is king." It is no more important than it is today. I mean it is absolutely imperative that the future benefits that you look at are cash. We've talked a bunch about how difficult it is to find capital, how difficult it is to find lenders and debt capital. All of these really come back to the simple need of cash.

So personally, I'm reluctant to use any basis of future benefits other than cash flows when I'm looking particularly at a distressed or impaired business in today's marketplace.

Historical cash flows we've talked about are likely of little value because the history is not likely to repeat itself at least in the short run in a distressed or impaired business. Again, focus on what our subject is – a distressed or impaired business. And so the historical cash flows from the good old days, the Halcyon days are not likely to be of much importance as we look forward.

So a DCF method, in my opinion, is the only reasonable income method to look at in this situation.

And once again, we've talked about this, but forecasts are critical as assumptions are difficult when valuing a distressed company. So really beat those forecasts up and look at whether they are really the right way to look at this thing.

If the situation allows, consider a "real options" approach to the discounted cash flows. In other words, look and see with a decision tree what are the potential scenarios and results and break that down into a situation where you look at the probabilities of the options. That's one of the ways when I talked about the client that I've got right now that had one customer and that customer is perhaps going to go south or has gone south. A real option type of valuation is something that you should take a hard look at in this situation.

Okay, Bob?

Bob Shortle: On the market approach, again, looking at this, as we've already mentioned and as everybody has kind of stated, this is much more problematic in a distressed company. It's more difficult to really ascertain what's comparable, where is their fit.

As the query is, is the market comparable if the market companies are not distressed? And I have to say, in general, no, unless you spend a lot of time trying to identify what's driving the current distress and how does it relate to how these other companies are being valued in the market.

And again, as I always say, finding comps is terribly difficult.

We get to the last point. Particular intangible assets might make the company valuable whether impaired or not.

I had a case a few years ago where we were asked to raise venture capital type money for a company and the company was in the medical industry. It had about $15 million in sales and it was losing several million a year. If you looked at it and didn't have a sense of even looking at cash flows and made some reasonable multiple cash flows, you would have never really come up with anywhere close to what the value of the business was worth.

When we got involved, we again spent a lot of time looking at comparable market transactions in that space. We found one particular one that was very close to it. It sold for 11 times sales. And looking at the business, you never would have guessed this thing could be anywhere close to that in the future.

But we felt it was close enough. We made a business case for us. So we took the company's projections, went out in year five, multiplied it times 11, put about a 50 to 60 percent discount rate on it as we thought was appropriate for the relative risk, and went to market marketing the story based upon that scenario. And in the end, we were able to get it financed with a post-money value of roughly three times the revenue, about $45 to $50 million post-money value in the company.

The key was that comparable was understood by the market. They believed in that multiple, it had made sense, and they believed in our discounted approach to the valuation.

So as you get into this stuff, it is very complicated in a valuation assignment to do things like that. But I think the main thing I would caution you, just because the company is terribly distressed, is losing a lot of money, it has maybe a good chance to survive.

So we don't totally miss these opportunities, I think we need to take enough time to figure out are there unique values in this company in the future that can be addressed in some reasonable capitalization approach.

Jim Alerding: And I would add to that, just looking at whether there are particular intangible assets buried within that business that may have a value that's not even being utilized by the company itself but has a value, as Bob says, in the marketplace is important to take a look at.

Let's move along, and Jim, let's throw these next couple of slides to you.

Jim Ewart: Well, I think we touched on this a little bit just a couple of minutes ago when we were talking about the income approach, Jim, about really starting to peel the onion back and let's get a good idea of what are underlying the forecasts.

I think we'd all agree, and then I think you made the statement as well, that a capitalization of earnings approach is probably inappropriate in today's environment, that a forecasting technique has to be employed in order to develop the cash flows that would then be valued.

So we need to have again an understanding of the business, so therefore, we need to look at our typical normalization items, non-recurring events that need to be factored out. We need to take a look at the balance sheet and identify whether there are non-operating assets, and certainly, depending on how we are determining the benefit stream, whether there are differences within the accounting and tax methodology and adjust appropriately for that.

But more importantly, and if we go to the next slide, we really need to identify the costs associated with the current situation and then how long are they going to last and then how long is the recovery period. And the things we're talking about there are restructuring costs, if those are needed, which could include a bankruptcy filing, whether there are extra legal expenses as a result of maybe doing some battles with our lenders, additional accounting expense. We, as a profession, are risk-adverse, so as part of our audit process, we may be spending more time that we're attempting to pass through as far as part of the expense.

We certainly have bank covenant issues. I think it may even be safe to make such a broad statement as there's probably not a borrower out there today that doesn't have a covenant issue with any of their lenders at this point in time.

And particularly if part of the plan is a refinancing or a restructuring of the capital base, which I think virtually every one of these is going to have, then we really need to have an understanding of what those are, identify over the period to which they relate, and then ultimately, readjust the expense side for those expenses trending out.

Jim, I don’t know what your thoughts are on this, but it may be that if we were using three to five year forecasts before, it may be that we now are pressing those out further because of the depth of what this may be, and given any particular industry, it may be that those periods might get forced out to, say, eight to ten years possibly.

Jim Alerding: Yeah, I think that’s an excellent point, Jim, and that those of you who have heard me do some of these before know that I’m a big fan of the H model which really allows you to go out and then take some intermediate steps to get to, for example, an ultimate discount rate or an ultimate cost of equity or capital out in the future.

But I think Jim’s right too that the discreet period may have to be longer. There’s no magic to these three years, five years, whatever. Obviously, the farther you get out, the less reliable sometimes the information becomes, but the nature of this recession is such that everything you read says this is not going to be a quick fix, so you almost have to go out there farther.

I think Jim’s points too, that he’s emphasized on this slide, are really important and we’ve beat on the fact that you shouldn’t look at historical results, but too often that means, I think to a lot of people, you don’t take the revenues that were there in the past or something like that. It’s deeper than that.

Jim mentioned, when you look on these slides, that specific extra expenses may happen in those first couple of years. I mean this is a DCF fan’s dream, this kind of a business, because you’ve got to really look at all those costs that are going to be loaded in, when they’re going to be loaded in, and because of the nature of a DCF, they’re obviously going to have an impact, a present value impact on the value of your business as to when they actually come about.

Jim Ewart: The other thought I had which was to Bob’s point where he was using the – I forget that multiple on revenues which I found astounding, but nonetheless, they hit it then with a 50 or 60 percent risk rate. What's important to remember here is that we're trying to ascertain a benefit stream. We're not risk-rating that benefit stream at this point. All we're doing here is coming up with the benefit stream and the risk of achieving it is totally another matter.

Jim Alerding: I think that's a fantastic point, Jim, because I think again when I teach these principles, I start out by putting up there too that value equals I over R, and I is the income stream and the R is the risk-rate of return.

And so what Jim's saying very accurately is that right now we're saying you've got to focus heavily on that I. What's that discounted cash flow? What's that income stream that you can look at in the future? And the better job you do of defining that, that makes it easier to come up with that risk-rate of return when you have to get to the R piece of the equation.

Let's go ahead and move along here.

Bob Shortle: I want to also emphasize on this normalization issue. We spend an awful lot of time in our business addressing this thing because many times the real earnings of a company are accidentally camouflaged by all the things that they have had to deal with in their distress.

We were asked recently to work on a company that was in Chapter 11 bankruptcy. The lender had had advisors who claimed that the company wasn't worth anymore than the bank debt. Once we had gotten involved and sorted through all those restructuring costs, all the legal expenses baked in there, all the accounting expenses, all the bank covenant violations – we got all that out there and got them back down to what is this company really doing in earnings – the debt was equal to just about 1.2 times EBITDA. We're going, "I think the company is worth a little more than that."

Jim Alerding: Yeah, exactly.

Bob Shortle: But yet, the lender had made the case that this company wasn't worth anymore than the debt by basically just focusing on the actual earnings to date, not trying to back out on any of these extraordinary costs that the company was burdened with in its Chapter 11 process.

Jim Alerding: Great points. Well, let's move along here so we can stay on time and make sure we get everything done.

Blake Lyman: Jim, this is Blake, if I could interrupt, I'd like to read today's CPE codes one more time.

Jim Alerding: Yeah, sure, you bet.

Blake Lyman: Those codes once again are 5543, 3146, and 2910. That's 5543, 3146, and 2910. Users of our meeting magnet will see those numbers appear on their screen right now.

I'd also like to remind our listeners today that the Morningstar article you referenced earlier from recent Business Valuation Update, the article on bankruptcy is available on our reading page for today's teleconference. So please visit that page and you'll be able to download that article for free.

Thank you, Jim.

Jim Alerding: Okay, Bob, let's go ahead and talk a little bit about the start-up companies. Obviously, it's a tough time to start any company and a lot of them that have started are in distressed situations and there's a lot of similarities. So why don't you take the ball rolling on that?

Bob Shortle: I think starting down right from the list of difficulties, I mean there's no magic in this and they don't really differ a lot again in good times or bad times but they're just more extreme now.

Obviously, you've got to assess management's capacity to build a business. You've got to analyze the market for the product. You know you have a limited operating history, so you're working very heavily off of projections.

Probably there have been losses in almost all start-up companies I've dealt with at least for a while, and so it's very critical to develop the projected cash flows.

Probably the area that's the most different right now is the development of an appropriate discount rate because you're going out there and sourcing financing and determining what the market will do with an early stage company.

Again, as we've stated before, there is an aversion to risk and so discount rates are higher generally to what I've seen in the past and so valuations are lower on these start-up companies.

And when you add to it the fact that 50 percent of start-up businesses fail within five years, when you're doing this in a distressed environment, obviously, it's probably even higher.

Going to the next slide on suggestions, now what you do with this when you're facing this, when you get involved in this, I think one of the key things is figuring out how important or how needed is this product or service. We see so many companies that come to us for us to help them raise money. And it's very difficult to determine is there really a need for the product. It may be a great product but is there a real need?

So quantifying that market and having them be able to make a case to you on what that market is and then trying to dimensionalize that market. That might be even calling the trade associations that Jim referred to earlier to help give you some details about what is the size of the market for this particular product and they may be able to help you. But that's important to see that it's big enough that somebody would care enough about it and you can build a business big enough to justify the projections you're giving.

Obviously, the uniqueness of product – if you're truly a commodity, it's much more difficult a lot of times to deal with early stage companies that have any capital intensity at all if, in fact, it's really a commodity. If it's unique, it can probably deal with the capital costs.

Industry growth prospects are obviously critical for a company in an early stage. If it's a declining business, it's hard to swim upstream.

In the likelihood of additional competition, the key is what are the barriers to entry. If it is a good market and you have a good opportunity and the barriers are low, it's likely that other competition will come in that may be better funded and make it much more difficult for this company to survive, and therefore, impairs value.

Future ability to raise capital is always critical in these things.

As we've said, you need at least three to five years of cash flow to really kind of come to grips with what this business could be and what it could be worth.

And then looking at those projections and then with all the issues in this current market and determining how reasonable they are based upon the size of the market, the need for the product, and so forth.

One of the things we have noticed, and again, I think this is not a bad thought, we have sent a lot of transactions when we raise money for venture capitalists. But one thing I've noticed that they do in certain firms is that they will look at a scenario – a cash flow scenario, a business scenario – and they will use the discounted cash flow but they do maybe four scenarios. And the way they'll do it is they'll figure out a scenario that the company fails, one that's being liquidated for. Second of all, they'll do a scenario that says, "We'll take your projections but we'll show a much more modest outcome, maybe a small profit and moderate success, and then value that scenario." And then we'll have one that hits the projections using the same again cost of capital structure, and then maybe one that exceeds the projections.

And then they'll come back and weight each of those ideas. What's realistically the probability of failure? What's the probability of modest returns? What's the probability of hitting projections? And what's the probability that you're going to knock it out of the park?

And then by weighting those, they'll come back to how they value the company from an investment standpoint.

In early stage companies, that's not a bad thought process because it forces you to think about all the outcomes and how likely are those to occur.

Again, knowing this current environment, the prospects of failure are just much higher than normal and I think it keeps you thinking through the logic of what you're concluding on.

Jim Alerding: And I think that's similar again to the "real options" theory that we talked about and I think that's a really good idea, and any distressed company should be looking at the things that are on this slide, not just start-up companies.

Again, with the economy, the way it's happened, the first thing to go is discretionary spending. So if you're in a product market that is highly dependent upon discretionary spending, that's something you better take into account pretty seriously in looking at the value of that company.

We have a question. Do the speakers have recommended data sources for such things as restructuring costs, legal expenses, refinancing costs, and other bullet points on the current slide?

Bob, why don't you take a shot at this? I've got some thoughts on it too but let's hear what your thoughts might be.

Bob Shortle: I don't see that question, so where you can find that kind of data?

Jim Alerding: Yeah, data sources for restructuring costs, legal expenses, refinancing costs?

Bob Shortle: I will say I haven't been in enough scenarios to see any consistent trend. I think a lot of times, if I had to say if I was facing a company situation that was in trouble, I might contact a bankruptcy attorney you know who's been through these multiple times and see what will their costs be, what will opposing counsel's costs be, because you've got a lot of different counsels. You've got to represent the debtor, the lenders, the unsecured creditors possibly, and so you have a lot of legal costs. They may each have a financial advisor. But typically, the bankruptcy attorneys have seen this a lot and they know what these things normally look like. So that's kind of where I think I would start on that piece of it.

Jim Alerding: Yeah, that's excellent.

Bob Shortle: The bank covenant side again is really whatever the bank agreement reflects and they should demonstrate in there what the costs will be.

A lot of times people will hire management on a temporary basis, or advisors or consultants and those are typically pretty easy to identify.

So I guess those would be my initial comments anyway on that question.

Jim Alerding: And I think to add to that, I think there aren't any real good sources other than as Bob mentioned, probably looking at maybe some bankruptcy attorneys who have done a lot of this.

It's fact-specific, so like everything else, when we keep talking about looking at the assumptions in these cash flows, a lot of times in these distressed companies where they're restructuring, a lot of times they're going through even a prepackaged deal with a bankruptcy or some sort of prearranged deal with their lenders. And so all the parties have kind of fleshed these costs out ahead of time and looked at them and have come up with the idea of what these costs are going to be. If they're actually in a bankruptcy proceeding, they've got to have a continuously updated 90-day look at the cash flows and the cash operating statements for the business. And so a lot of times you can pull those costs out of that particular scenario. So I would say that's a good way to look at it too.

Jim Ewart: Jim, I was going to mention that in a situation like that, obviously, cash is king. I mean it always has been and continues to be. And what I mean by that is that hoarding cash immediately before the event, one, precludes the 90-day look-back as far as preference payments and those kinds of things, but what it also does is frees up cash for operations post or while you're in bankruptcy, not immediately before. So instead of paying out funds to service AP and debt, you hoard the cash, build it up, put it in the bankruptcy, and use it then to operate until you can sort out your new sources of capital.

Jim Alerding: I want to keep us moving here because we are getting to the point where I want to make sure we finish but there's a question. Bob, I've got to throw this one back to you as our questioner says, "I don't know that the statement of over 50 percent of start-ups fail is true. Where does that statistic come from? The SBA study indicated that the failures are a function of start-up capital and the number of employees." So Bob, do you want to take that one?

Bob Shortle: Yeah. I will say I don't know if I have any great response to that other than I have seen a lot of studies over time, and again, a lot of times they focus on a five-year timeframe. And in a five-year timeframe, again, the probability of making it – I know I've seen this – is in the range of 50 percent. It might be higher. It might be lower.

But I guess the main thing I would tell you in this is that it's still quite high from my experience, and in this current environment, it's much greater because the challenges, particularly to get the financing, are so great and sometimes to get new customers can be so great.

Jim Alerding: And what about the fact that it might be a function of start-up capital and the number of employees? I have not seen that particular SBA study but I think I might question that as an absolute statement because I think there are a multitude of factors. They may be some of the most common but I would say there could be a multitude of factors that make a new start-up business fail.

Well, let's move along so we can stay on our timeframe here.

The next one is we want to start talking about valuing mature and declining companies, and there are difficulties, so this is the other end of the scale. These are distressed companies that may be mature and declining and it may not have anything to do with the economy. These might be calculating the values of mismanagement. In other words, this company may be distressed or impaired because it's got poor management and management may have poorly managed the assets.

They may have underutilized strategic advantages. The example that Bob gave about where they looked at the marketplace for that company that had been losing money and they were able to show that in the marketplace that particular company had some strategic value that was being underutilized by its current situation.

Now there may have been poor investment strategies. I worked for a company for a number of years that had the product SOS scouring pads. I'm sure everybody's familiar with those if you're old enough anyway. And the SOS pads, it was a great business. It was a cash machine. The problem was they paid too much for it. And so as it was structured, it wasn't very much of a profit maker because they had too much debt on it and they paid too much to get the product base. But as a product itself, it had a lot of value. So you can be overly conservative or overly aggressive on those issues.

Addressing poor revenue growth and fading margins is another thing that can be looked at to say how can this business turn around, what's the real value in this business. So sometimes you've got to look at maybe what you normally might consider synergistic value or strategic value to say well, maybe the buyer can do a better job with this than the current owner. So that's difficult too and how do you take that into account in your value.

Let's move along.

Jim Ewart: What are the suggestions? How do we deal with those kinds of issues? And I guess we ought to distinguish here, Jim, between a controlling interest and a minority interest. I think the kinds of comments that we are making relate to control situations and certainly not minority because there's not a whole lot that can be done. Although, if the firm was burning, one would assume that someone has taken action to maintain it. But I think we're talking about control situations.

We've talked about assessing the reasonableness of the projections and the assumptions. I think we've said enough there about that but we just can't overemphasize the importance of continuing to do that.

Management having a plan is – Bob might speak to this more – but the need for planning can't be overemphasized in today's environment. And that plan needs to be then quantified and qualified both so that management can communicate to those that are involved with the recovery and what that cycle might look like.

Challenging the assumptions, I think, is part of our job even more so in today's environment.

One thing, and we haven't touched on this yet – Jim, maybe I'll bring this up – is – has our risk – that is, that work that we're doing with respect to valuing these kinds of companies – has our risk broadened? Is the user of our report going to be putting more reliance on it than maybe they have in the past and how does that affect us? That's a concern that, as a practitioner, I have.

Jim Alerding: Well, I think that's a good concern, Jim, a valid concern in the sense that there are going to be more failures, there are going to be more businesses that probably don't meet our expectations.

But I think we've got to look at the other side of that too. If we get too conservative, we could be just as exposed from a risk standpoint if the business actually performs at a value level higher than what we've valued it at or anticipated.

So yeah, I think there could be some of those situations.

Let's move along to the next slide if we can.

Jim Ewart: But what I would do there is I would test the reasonableness of the assumptions and certainly in our conclusions of value. In the ABV course, there's the financing test – that is, when you get your conclusion of value, what's the payback period under reasonable financing terms, whether or not the cash flow can support it. Those kinds of tests, I think, are important to what we're doing.

And then let's not lose sight of the fact that the macro and micro effects of the situation need to be addressed and factored into the overall DCF forecast that's being used on a discounted basis to value the company.

One question we may get into, and I may hold it, but one thought that I had was whether or not risk rates associated with the benefit stream should be different than the risk rates associated with the terminal value. Why don't we hold that and maybe we'll talk about that in just a little bit.

Jim Alerding: Okay, let's move along. Good question though. Blake?

Okay, valuing cyclical companies. The difficulties in valuing a cyclical company – and I kind of alluded to this – is we've got to look at both the overvaluation and undervaluation issues. Many analysts tend to overvalue companies when an industry is thriving and undervalue the company when there are industry downswings. So I think you've got to be very cautious in your approach and make sure that you don't get either too conservative or too aggressive in looking at that.

So how to avoid that, well, we've talked about reviewing industry periodicals, historical trends, industry forecasts. Where do you get that information? Once again, those trade associations are invaluable. Now they can give you that information and more in a lot of cases. But that's the place I tend to go first, is to look at the associations, look at, as I said, the periodicals in there and they almost always will have industry forecasts that are available.

Keep in mind that depressed industry growth rates generally return to normal, generally, so you've got to look at the specific industry. In today's world though, the question that's begged by that statement is when are they going to return to normal. And that may be and probably will be on an industry by industry basis. The automobile and the commercial real estate and residential real estate and building trades come to mind as industries that when are those going to return to normal. It may be a long haul.

Some of the other industries, some of the computer industries and things like that may return to a normal basis much more quickly.

In an industry downswing or upswing, consider the entire business industry cycle and use the average revenue expenses in the determination of the value.

So again, look toward the industry as a whole and take that information you're able to get and use that to your benefit.

Okay, let's move along.

Jim Ewart: Jim, we found this quote, and I didn't put it in here to be argumentative, but distressed entities generally have higher rate risk profiles, which I believe is absolutely true, and lower profitability levels, which is likewise to be true, compared to their healthy competitors, and a proper discount for distress, usually at least 20 percent, therefore, must be built into the valuation.

And I guess the question here is whether or not today we should be separately identifying a risk rate associated with the distressed nature of this or whether it's really just a part of the overall build-up, and I think it's part of the overall build-up in determining the risk rate.

And we're not talking about here the equity risk premium and all that that's out there with respect to whether it should be 4 or whether it should be 6 or whatever the number should be. What we're really talking about is what's the overall risk of achieving the cash flows that are being forecasted.

Jim Alerding: I think that's good because I think we get lost in the forest trees sometimes.

Jim Ewart: Well, I know I do.

Bob Shortle: I know I do.

Jim Alerding: Yeah, I do too, in the CAPM or the build-up and we need to stand back and say, "Does this make sense for this business?" when we come up with a final discount or cost of capital rate.

Jim Ewart: Exactly.

Jim Alerding: Okay, let's move along.

Jim Ewart: And the other issue here that we need to make sure that we identify is that we also don't confuse the increased illiquidity risk with the risk of achieving the cash flows. And I think that Lance from FMV has an excellent article – I think it was in the August issue – that addresses this specific point, that the illiquidity risk has increased but it's a separate risk from the cash flow risk in the DCF benefit stream.

Jim Alerding: Right.

Jim Ewart: If we go to the next slide – and I don't know whether default spreads. In the build-up, it's not often, if ever, that you see default spread being factored separately and I'm not suggesting that it would be today. But what it is, is that it is a component of the build-up and certainly in either the equity risk premium that is market driven or the company specific risk. Either one, there is a default risk associated with both of those.

But whether or not we're going to return back to levels that were pre this period in our economy, I'm not sure of, and one question I have that's still inside of me is whether or not there has been a fundamental change in investor profile that is not going to cycle back to historic levels.

I've heard several folks, particularly in the real estate industry and residential real estate, talk about that there's been a fundamental shift in buyers and what they are demanding, what the product they're demanding is, and I'm wondering whether or not that shift in attitude – that is, they want smaller, compact – whether that's going to be just cyclical or whether it's permanent, and they're suggesting that it is permanent, and whether those kinds of attitudes are then going to filter into the overall risk rates associated with investing.

Jim Alerding: Or is that part of that income stream as we talked about, knowing the industry and knowing the territory, so it could be either.

Well, let's make sure that we move along here, and I want Bob to talk a little bit about the appropriate multiples.

Bob Shortle: As we've discussed, these are challenges, but nevertheless, they can be utilized well. Broader valuation matrices may make sense such as enterprise multiples of revenue.

One thing, we have a transaction right now we're in the market with we started about a year ago. The company was losing money and had not made money for some time. We found that the comparables were selling for around .8 to .9 of revenue. And this was again a little bit more of a commodity type business. We felt our client could grow into that number and that it had some unique value, but nevertheless, it was a company losing business. And we've now been to market, we've gotten a bunch of offers in, and it looks like we're going to be right about .9.

So the key is that revenue can be a good metric when you still feel fundamentally it's a good business but yet they just haven't achieved earnings at this point or not right now.

We've talked about again how you analyze the comparables. But what I would like to tell you from my own experience again is that looking at multiples over a broader period of time can be very helpful to you because if you look at very much snapshots in time, you get tremendous distortions particularly in a distressed environment.

For example, if we started into like, say, 2007 and we looked at P/Es, and the P/E was 10 on a company, as the economy starts to slide, typically earnings, looking trailing 12 months are still there, but yet the market's going down so the P/E goes down quickly.

Then when you turn it around, you start coming out the other end. The earnings that have been coming have dropped precipitously. The market started to go up as you found in Wall Street. And so the P/E then pops back up.

Well, the key is that probably the business didn't change that much. The probable buyers or the people who invested in it didn't look at it that much differently, but yet the metrics that you're working with, the comparable metrics changed violently as you went through that distressed cycle.

So I would tell you in this current environment you've got to spend the time to look to see where are we in that cycle and are the comparables we're looking at appropriate for where that company is in its cycle.

Jim Alerding: Good points. Let's move on, and I want to probably not spend any time on these next couple of slides but to let you know that these are in there. And we had had some questions earlier about the liquidation premise and how you determine the values and here are just some thoughts that you can take home with you on this slide and on the next couple of slides probably that will just give you an idea of what to look at when you're looking at the specific value of specific assets in a liquidation mode and help you kind of determine what that value should be so that you've got a good comparable to any other method or approach that you're looking at in order to value the particular company.

Bob Shortle: I would throw one comment into all that. I mean I think they are pretty self-explanatory and you can go through them on your own time. But the one thing I've noticed and people who have looked at and have analyzed the situations, if there's one thing they've missed, it's the cost to dispose of the assets, whether it's receivables to collect or inventory they've got to sell off or fixed assets. I mean I've seen so many fixed asset situations recently where they're valuing at almost zero. And so I think a lot of times it's easy to miss the time and cost to get rid of assets.

Jim Alerding: Good point, absolutely.

Let's move along here. I think we're about to finish it up. And so always consider what's the condition of the industry in which the company participates, how much of the company's distress is related to mismanagement or how much is related to the economy, does the business have access to capital, has the risk been appropriately accounted for in your projected cash flows, in the discount rate, in both. Be careful not to double count but also make sure that you do count accurately. And as Jim pointed out a number of times, and all of us have in this presentation, the key is getting the right cash flows to the extent that you can.

Have valuation multiples been developed using comparable companies? And Bob told you some of the things to be careful about when you're doing that.

And then finally, what's the probability of bankruptcy? Because that obviously has a great impact on what the business value is actually going to look like.

So I want to thank all of you for attending today and being on the line and I think we've hit our number just about right on the mark and we hope that you have enjoyed the presentation.

We have one last question, which, Jim, I'm going to throw to you real quick. Where do we obtain the default risk spread premiums?

Jim Ewart: In Damodaran's book, *The Dark Side of Valuation*, he's got several chapters that talk about that, certainly how to even go about calculating it over and above – I think Bob had mentioned Z scores. There are several other methodologies that are certainly appropriate.

So what I would suggest you do is go to Damodaran's web site, take a look, and there's a good bit of information there.

I believe Morningstar also has some on their site as well.

Jim Alerding: Let's go to that last slide, Blake, so we give credit to Mr. Del

Genio. Bob Del Genio was very helpful in letting us use some of the information that he put together for another presentation I did with him previously, and I want to make sure that we give him appropriate credit for his input into all of this.

So once again, I thank the participants and I thank also our presenters today. Jim Ewart and Bob Shortle, I think you guys did a great job and had some great perspectives coming from different viewpoints, and we hope that all of you enjoyed it very much.

And it is now 100 minutes, which we've hit directly on the nose, and I will throw it back to Blake.

Blake Lyman: Well, thank you, Jim. BVR would like to echo you thanks, not only for your expertise today but also Jim Ewart and Bob Shortle as well. We'd like to thank our listeners for attending and the CICBV for their support today as co-presenters.

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