Bloomberg BNA

BNA's
Bankruptcy Law Reporter™

Reproduced with permission from BNA's Bankruptcy Law Reporter, 26 BBLR 1472, 10/23/14. Copyright © 2014 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

Genco Shipping: Valuation Lessons Learned From "Underwater" Equity

BY JORDANNA L. NADRITCH, MICHAEL S. FOX AND ADAM H. FRIEDMAN

OLSHAN FROME WOLOSKY LLP

Valuation is a balance of art and science. In the bankruptcy context, valuation determines which constituents are entitled to a recovery and which are not, making it a centerpiece of the restructuring process. In *In re Genco Shipping & Trading, Ltd.* (*In re Genco Shipping & Trading Ltd.*), 2014 BL 184639, 513 B.R. 233 (Bankr. S.D.N.Y. July 2, 2014), the federal bankruptcy court in New York faced the question of whether the debtor's valuation enabled equity holders to receive a recovery. Following a six-day trial, U.S. Bankruptcy Judge Sean Lane confirmed Genco's plan concluding that the discounted cash flow ("DCF") analysis — often touted as the gold standard and key metric used to value companies — was not a reliable measure of value for the dry bulk shipping business and instead accorded significant weight to an alternate asset-based valuation methodology, net asset value ("NAV"). The NAV method left the equity holders "out of the money" (26 BBLR 910, 7/10/14).

Michael S. Fox is the Chairman of Olshan's Bankruptcy & Financial Restructuring Group. His diverse experience involves representing clients in all areas of financial restructuring, including Chapter 11 reorganization cases, out-of-court workouts and restructurings of troubled companies.

Adam H. Friedman is a partner in the Bankruptcy & Financial Restructuring practice at Olshan and represents clients in corporate and real estate restructurings and Chapter 11 cases.

Jordanna L. Nadritch is a partner in the Bankruptcy & Financial Restructuring practice at Olshan and advises clients on a broad range of bankruptcy and restructuring matters.

Genco, one of the world's leading providers of maritime transportation services for dry bulk cargo goods, was faced with a highly leveraged capital structure. On April 21, 2014, Genco filed a prepackaged Chapter 11 case in the U.S. Bankruptcy Court for the Southern District of New York seeking to implement a comprehensive restructuring plan (26 BBLR 566, 4/24/14). The prepackaged plan — which set the case on a fast track toward confirmation — garnered unanimous support from Genco's secured lenders and holders of its unsecured convertible notes, providing secured lenders with more than 80 percent of the common stock in the reorganized Genco as well as the right to purchase an additional 7 percent via a backstopped rights offering. The prepackaged plan provided that while unsecured creditors would be paid in full, old equity holders were only to receive out of the money warrants in exchange for their interests. The transaction was premised on an enterprise valuation between $1.36 billion and $1.44 billion derived from a range of values under the NAV method.

Less than three weeks into the case, the United States Trustee appointed an official committee of equity holders. The equity committee, comprising several notable investment funds, devoted significant resources to a campaign challenging the proposed restructuring and Genco's valuation. Working within the tight time frame set by the Court, the equity holders' campaign culminated in a six day confirmation hearing during which Genco and the equity committee put on testimony regarding the competing valuations. The debtors asserted that their plan value was premised on the NAV analy-

COPYRIGHT © 2014 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 1044-7474

sis, a methodology commonly applied to shipping companies in non-bankruptcy contexts and a more accurate valuation of the dry bulk shipping business. The equity committee's valuation placed greater weight on the DCF analysis. At the end, Judge Lane agreed with the debtors' valuation experts that the speculative nature of rates for the debtors' dry bulk shipping business made discounted cash flow estimates unreliable.

From a practical perspective, the Genco opinion is instructive on several points. First, the Court's favor for the NAV analysis demonstrates that the nature of the debtor's industry is almost always a driving element in valuation. If the industry is unique, the first step in a valuation fight is persuading the court that your valuation method best suits that industry. The Genco decision is significant because it establishes a clear precedent rejecting the DCF method when determining the enterprise value when cash flow is volatile. Dry bulk is just one segment of the larger shipping industry, and many other segments share the characteristics that the bankruptcy court cited to support its conclusion that accurate projections were not obtainable.

The decision, however, will likely have farther-reaching consequences. Shipping is not the only industry with notable volatility; other industries may soon become subject to the application of the NAV approach for valuation. Indeed, as the Court and commentators have observed, the NAV approach is most appropriately used to value companies with significant fixed assets and few intangible assets, such as real estate holding companies or those in the natural resource field. In these industries, projections used in the DCF model are more instructive for liquidity purposes as opposed to a value determinant. The converse is true in fixed-asset light industries and companies with considerable intangible assets, such as retail. In those instances, the DCF and market-based approaches are a better indication of value and will likely continue to be figure prominently in valuation litigation.

Second, there are fundamental strategies in presenting and defending any valuation dispute. In Genco, the Court noted that the equity committee presented an alternative explanation rather than adequately challenging the debtors' valuation. Judge Lane made clear that it is simply not sufficient to oppose one valuation methodology by advocating for another. The equity committee's failure to contest or rebut each part of the debtors' analysis was a recurring theme in the Court's decision. In several instances throughout the opinion, the Court noted that key elements of the debtors' valuation argument went ''unchallenged'' by the equity committee, most notably by the absence of a countering analysis under the NAV method.

Yet, it is worth pointing out that the equity committee was no doubt hampered by the expedited nature of the case, with the confirmation hearing held less than 60 days after the case was filed. Indeed, the element of speed was challenged by the equity committee in the first few weeks of the case; however, the case's fast track was not extended.

Third, and perhaps the most significant takeaway from the Court's decision, the result speaks to a more practical analysis by the Court, which made it a point to suggest that the best way for an investor to truly prove value is to put its ''money where its mouth is'' or find a third party who will agree to a transaction at the value that they are urging the court to believe. The decision follows many others where courts have little sympathy for the underwater lender who argues the assets are worth more than they are being sold for, yet does not submit a bid of its own. Judge Lane wrote, ''The Court finds it telling that no equity holder, including large hedge funds on the Equity Committee, has expressed any interest in investing its own money in a transaction involving the Debtors.''

This is not the first time — nor will it be the last — where a court is hard pressed to find value when equity owners (or third party investors) do not step up to commit their own funds. The Court's view in Genco demonstrates that investors may need to become more forward thinking and assess if they are prepared to support — both through empirical means and their wallets — their view of a higher valuation. This would translate into investing their own money or perhaps proactively finding a third party that will invest the funds to support their valuation. The challenge is far greater on such expedited timelines, forcing investors to act early (even before a bankruptcy files) and expeditiously.

We learn from the Genco decision that parties in bankruptcy valuation disputes cannot rely on the DCF methodology across the board and bankruptcy judges have the discretion to value companies using a variety of different methodologies depending upon the industry. Likewise, parties and experts are well advised to be prepared to not only utilize the appropriate valuation method but also be ready to challenge an alternative methodology with expert opinion and evidence. As stated above, judges are often persuaded by those who are ready to commit capital and funds to drive the value they are advocating for. Investors may also need to expand their focus and perhaps spend less time fighting early ground battles in bankruptcy cases and instead spend more time and resources for the larger war: offering up a transaction that truly offers a greater distribution to the estate's constituents.

 COPYRIGHT © 2014 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 1044-7474