

Business Valuation Monitor

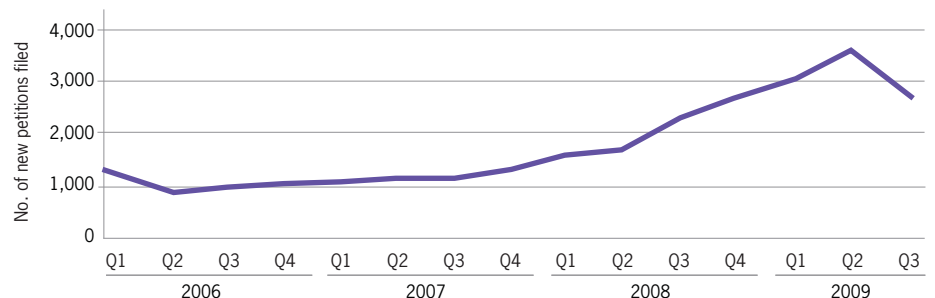
Value creation perspectives for corporate executives and the investment community November 2009

The blueprint for life after bankruptcy

The adjacent chart contains statistical confirmation of a trend that all observers of corporate economics know: filings for reorganization under federal bankruptcy law have been experiencing double-digit growth almost uniformly since late 2007. Even if the latest numbers, showing a drop in entity filings during the third quarter of 2009, indicate a moderation of the trend, the economy still is absorbing the effects of this downturn and the filings yet to come.

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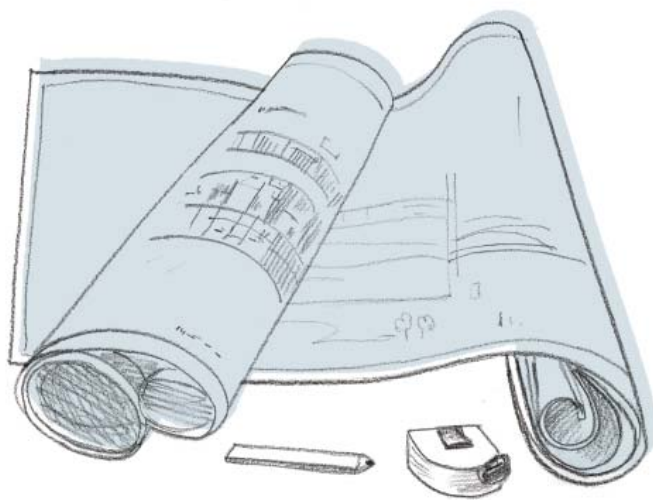
Chapter 11 filings
by corporations and partnerships



Source: Bankruptcy Data Project at Harvard; <http://bdp.law.harvard.edu>

Valuation plays a central role in Chapter 11 bankruptcy negotiations and is key to a fresh start. Read more in [The blueprint for life after bankruptcy](#).

The blueprint for life after bankruptcy (continued)



So let's examine the following questions:

What happens after the filing of the Chapter 11 bankruptcy petition, and how does valuation serve as the touchstone in the process?

In Chapter 11 reorganization, the objective of management and its advisors is developing a plan of reorganization (the "Plan") that will be confirmed by the Bankruptcy Court, leading to emergence from bankruptcy protection and a return to competitive operations — life after bankruptcy.

At its simplest, Chapter 11 reorganization is a formal, court-supervised process to:

- provide temporary protection from creditors;
- maximize the value of the company, primarily through eliminating excess debt, exiting unprofitable operations, and/or revising contractual relationships;
- establish the value of the reorganized company; and
- allocate that value among the various parties having a claim against the company.

In a successful reorganization, the debtor company and its advisors prepare the Plan and a disclosure statement that groups the creditors into classes and includes an estimate of company value. The Plan becomes effective if, and when, the debtor solicits a sufficient number of votes in support of the Plan.

Central to the reorganization objective and confirmation of the Plan is the **reorganization value**, or the estimated enterprise value of the debtor company — the economic measure of what the market believes the ongoing operation is worth. Reorganization value is more a product of the negotiations between debtor and creditors than an application of generally accepted valuation principles. And central to the reorganization value are the issues of:

- What is future cash flow capacity of the firm?
- What is the future risk profile of the firm, represented by the discount rate applied to future cash flows?
- What are the appropriate valuation multiples to be applied to firm measures such as revenue and EBITDA?

The reorganization value is crucial to creditors, since it indicates who will be paid, and how much will be paid. When the reorganization value is determined, it will establish whether or not:

- a primary secured creditor will obtain periodic payments on its restructured loan, or equity in the reorganized firm;
- general unsecured creditors might receive some return on their pre-petition claims; and
- holders of former equity interests will retain any continuing stake in the reorganized firm.

Although it is the responsibility (and exclusive right for a specified period) of the debtor's management to file the Plan and disclosure statement, in rare cases, other parties in interest (typically creditors) may petition to file an alternate reorganization plan. Generally, competing plans arise from differing views on what the company is worth.

Life after bankruptcy begins with a "fresh start" — Fresh start valuation and accounting. What is it and why is it important?

Confirmation of the Plan leads to another requirement for valuation in the bankruptcy process — fresh start valuation and accounting.

Upon emergence from bankruptcy, management is required to apply the provisions of fresh start accounting to its financial statement in accordance with Generally Accepted Accounting Principles ("GAAP"). Under fresh start accounting, a new reporting entity, the "successor company," is created, and the recorded amounts of assets and liabilities are adjusted to reflect their fair value. As a result, the historical financial statements of the pre-bankruptcy firm are generally not comparable to those of the successor company.

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The blueprint for life after bankruptcy (continued)

Entities, whether public or private, must comply with Section 852 of the Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC"), *Reorganizations*. Fresh start accounting was previously covered under the AICPA's Statement of Position 90-7 ("SOP 90-7"), *Financial Reporting by Entities in Reorganization under the Bankruptcy Code*. Section 852 calls for reorganizing entities to apply fair value concepts to determine both the reorganization value and new basis of financial, tangible, and intangible assets in financial reporting.

For financial accounting purposes, the reorganized firm is treated similarly to a newly acquired entity. The reorganization value is allocated to company assets in compliance with ASC Section 805, *Business Combinations* (previously Statement of Financial Accounting Standards ["SFAS"] No. 141R). Determination of asset values also must integrate the concepts of ASC Section 820, *Fair Value Measurements and Disclosures* (formerly SFAS 157).

Of particular importance, though, is that determining the fair value of assets can be complicated in circumstances where a company is invested in tangible assets of a declining or displaced industry, which could be impacted by functional or economic obsolescence, or when the distress encountered by the company prior to and during bankruptcy could have created negative associations that would impact intangible value. Valuation involving these factors must be robust to withstand review by third parties.

Fresh start valuation and accounting follows the reorganization process and establishes the financial reporting foundation that will serve as the company's blueprint for life after bankruptcy. The quality of the valuation can make a significant impact on the determination of value and not all valuations are created equal.

What are the implications of "fresh start" valuation?

Although the firm will assume a financial reporting position that will maximize depreciation and amortization through a re-set of the tangible and intangible asset basis, the de facto stock acquisition treatment for tax reporting in fresh start will likely result in differences between financial and tax reporting. Previously fully depreciated assets used in operations will again have a depreciable tax basis that throws off depreciation. Previously unrecognized internally developed intangible assets will be recorded on the balance sheet and generate prospective amortization. After completion of the fresh start valuation, the generation of a deferred tax liability could result in the creation of goodwill on the reorganized company's balance sheet.

Of additional concern is the circumstance where the entity's operations encompass more than one reporting unit. The fresh start valuation must then proceed to establish the fair values of the tangible and intangible assets in a manner that is cognizant of the future impairment testing of long-lived assets or goodwill under ASC 360-10-30, *Property, Plant and Equipment*, or ASC 350, *Intangibles - Goodwill and Other*, respectively.

Several factors will also impact the cost structure of the post-bankruptcy company. During reorganization, the company has the opportunity to shed itself of leases with financially unfavorable terms, a true advantage where lease costs are material. Interest expense, a significant pre-bankruptcy cost, may be significantly reduced, leading to cash preservation. Unprofitable operations may be exited. The post-emergence company will be newly competitive in a manner that may lead rival companies that forestalled bankruptcy to find themselves in a condition of "bankruptcy envy." Perhaps, however, the lingering damage of bankruptcy to customers' perceptions will weed out the formerly weak performers. Every bankruptcy cycle presents these same questions – what value remains in distressed and/or over-levered companies, and how will the market respond to reorganization?

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The blueprint for life after bankruptcy (continued)

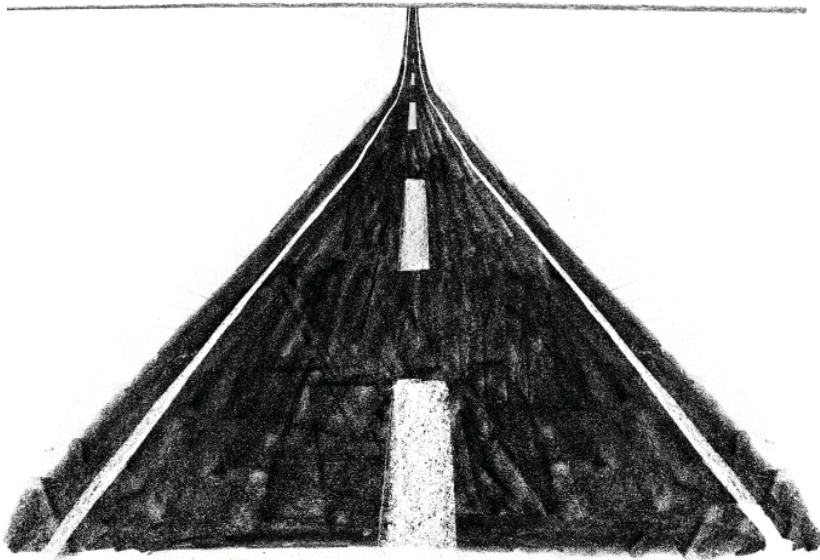
The bottom line

Bankruptcies have been and most likely will continue to be on the rise for some time, and while this unprecedented environment is challenging, it presents many opportunities for those who understand how to strategically manage the process. In some cases, post-bankruptcy companies gain a competitive advantage as they emerge in a solvent position. Insightful valuation analytics during this process are key to the best possible outcome and provide a solid foundation for a fresh start.

There are many tough questions presented by the bankruptcy process that can best be addressed by trusted advisors who specialize in restructuring, reorganization and valuation.

Valuation is a complex and evolving field. It includes elements of finance, accounting, law, economics, management and other disciplines. Because fresh start valuation has significant financial, legal and tax implications, a high level of care should be exercised in choosing a qualified and credentialed valuation professional. In these situations, it is critical to have a team with a proven track record of producing positive results and solving complex business problems.

Grant Thornton LLP's Valuation and Corporate Advisory & Restructuring Services professionals stand ready to help you address the issues of life before, during and after the bankruptcy process. We help our clients with today's toughest business issues and offer the experience and expertise of fully cross-functional teams to help get you back on the road to opportunity. •



About the author

Susan Nunamaker is a senior manager in the Advisory Services - Valuation Services Group of Grant Thornton LLP located in Charlotte. Prior to joining Grant Thornton, Susan led the valuation practice at a middle-market public accounting firm. Additionally, Susan participated as a senior valuation specialist and vice president at an international valuation consulting firm.

Susan has over 24 years of extensive experience valuing businesses, business interests, and intangible assets. These engagements have included accounting and tax reporting, fresh start valuation, insolvency and restructuring, impairment testing, property tax adjustment, litigation support, due diligence and pre-transaction analyses. Susan has worked on a number of confidential engagements both inside and outside of formal bankruptcy. These projects range from multinational organizations with multi-billion dollar worldwide operations to smaller, local operations. Susan is also an accomplished speaker on cutting-edge valuation issues and bankruptcy.

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