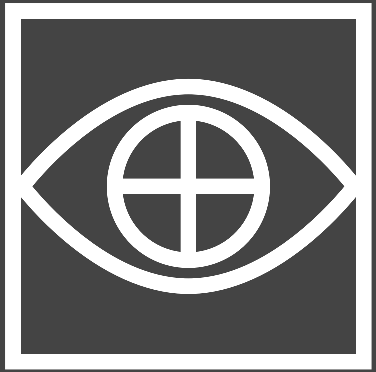

A Multi-Stakeholder Perspective

July 2020

Valuation under the WHOA

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1. Introduction

Valuation under the WHOA

After a long run-up, the Dutch equivalent of the UK Scheme of Arrangement and the US Chapter 11 has been put to parliament and unanimously voted favourably to the Senate by the House of Representatives, including a limited number of amendments to the draft bill. The proposed bill – named *Wet homologatie onderhands akkoord*, or WHOA in short – facilitates debtors to offer a tailor-made out-of-court restructuring plan to all or some of its creditors and shareholders, while remaining in control of the company. Implementation of the bill is expected to take place in the second half of 2020. The recent developments around the COVID-19 crisis further increase the need for such bill.

Without the WHOA, individual shareholders or creditors can frustrate a restructuring process by refusing to consent to a restructuring plan. By retaining their right to seek (full or partial) repayment of their claim, they can disrupt a restructuring plan and force other, more senior creditors to take a disproportionate haircut on their respective claims or even render the restructuring plan infeasible and force the company into insolvency proceedings. This is referred to as the holdout problem, which we will illustrate further in Chapter 2.

The WHOA aims to largely resolve the holdout problem and, as a result, enhance value preservation and equitable value distribution for the various stakeholders involved. This should result in significant economic benefits compared to the current, pre-WHOA procedures. And although the start of a restructuring process will still largely be as we know it today, an extra implementation tool for the restructuring is given to those involved. The WHOA will likely also act as a "stick" that changes the behaviour of stakeholders already earlier in the process, contributing to the value preservation and equitable distribution even if the restructuring is not effectuated through the WHOA.

Under the WHOA, the fundamental ownership rights of stakeholders can be overruled, provided that certain preconditions (safeguards) are met. In that context, two value concepts come into play: the reorganisation value and the liquidation value. The reorganisation value represents the value of the debtor firm once the restructuring plan has been sanctioned by the court, whilst the liquidation value is the value of the debtor firm in case of bankruptcy (the latter being the alternative if a restructuring via the WHOA would not take place). Both these terms will be outlined in more detail in Chapter 3.

Finally, in Chapter 4, on the back of a few examples, we will illustrate the importance of valuations in a restructuring through a WHOA procedure and raise awareness of how the multi-stakeholder perspective impacts valuations under the WHOA. We close with a discussion on the benefits and challenges of the WHOA in Chapter 5.

2. The WHOA improves a company's ability to restructure its business, thereby preserving value

2.1. The WHOA allows for a court-approved restructuring plan

After introduction of the WHOA, a company may initiate the WHOA procedure when the company can provide evidence (e.g. with a cash flow forecast) that, in time, it will not be able to repay its debts. Alternatively, if the company refuses to do so, any of the company's creditors, shareholders or works council may ask the court to appoint an independent restructuring expert to prepare such a restructuring plan on the company's behalf.

This plan should be prepared taking into account and engaging with the various stakeholders involved. It should include the aforementioned liquidation and reorganisation values, and the amounts to be written off (and/or the amount of new capital to be put up) by each class of shareholders and/or creditors.

Each shareholder and creditor affected by the plan is assigned to a class (based on the priority and rights of their respective claims before and/or after the restructuring) and given the right to vote. A class supports the plan if more than two-third of the class votes in favour of the plan. In principle, the court can confirm the plan in case at least one class supports the plan.

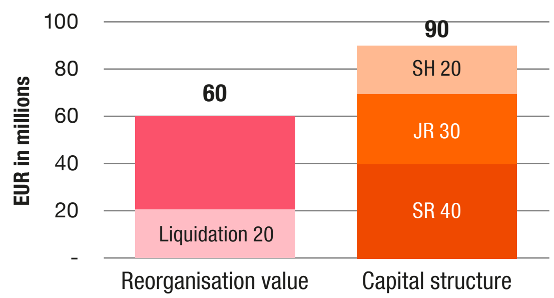
Various safeguards are in place to protect the interests of individual creditors and shareholders. Furthermore, given the impact of the WHOA on fundamental ownership rights, the lawmakers have limited its use to situations in which, absent a restructuring, the company would most likely go insolvent.

2.2. Holdout positions currently often frustrate restructuring processes

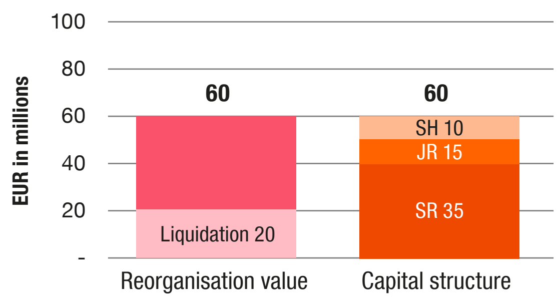
In the Netherlands, a company in distress currently (i.e. before introduction of the WHOA) has effectively two options to accomplish a restructuring: either through a consensual deal with all relevant creditors and shareholders involved, or through an insolvency. A consensual deal is preferred, since the recoveries for creditors (in aggregate) are generally significantly lower in an insolvency procedure. However, with only a consensual deal as a better alternative to an insolvency, inherently holdout positions are created for

Example 1 Simplified example of a holdout position pre-WHOA

Pre-restructuring



Post-restructuring



Company X has a reorganisation value of EUR 60m, with the total claim on the company amounting to EUR 90m (capital structure), consisting of EUR 40m in senior debt, EUR 30m in junior debt and EUR 20m in equity (book value). In case the company would be liquidated, a value of EUR 20m could be recovered, resulting in significant value destruction for all creditors (and the wider economy / society, e.g. through loss of jobs).

For the business to survive, the junior lender has indicated it is willing to convert its debt to equity. Without the WHOA in place, the shareholder cannot be forced to cooperate with a debt-for-equity swap. In case the existing shareholder decides not to cooperate, this could for example result in both the junior and senior creditor writing off part of their debt with the shareholder retaining (part of) the equity in order to avoid a deadlock. This implies that the recovered value is not distributed based on economic entitlement (based on which the shareholder should be last in line),but based on the holdout position of the existing shareholder.

Since a bankruptcy is a very unfavourable outcome for all parties involved, the senior and junior will most likely agree, albeit that their economic rights are not adhered to.

some parties that can significantly delay or frustrate a consensual deal. This can make it difficult for a company to implement a successful restructuring in a timely manner; if one party refuses to cooperate, the restructuring could fail. Alternatively, the holdout positions lead to a situation where a restructuring is achieved, but the value is distributed based on holdout positions rather than economic entitlement, which is not fair from an economic perspective. Refer to ***Example 1*** for an illustrative example.

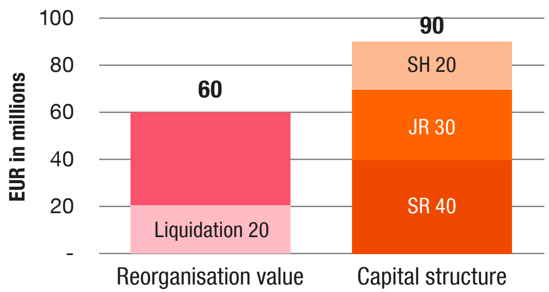
2.3 Holdout positions will to a large extent be resolved under the WHOA

The proposed WHOA bill would – to a large extent – resolve this situation. Holdout positions can be overruled, since the agreement can be imposed on individual creditors or shareholders that have voted against the plan.

In ***Example 2***, we illustrate how holdout positions can be prevented under the WHOA, building on the situation introduced in ***Example 1***.

Example 2 Elimination of holdout positions under the WHOA (simplified example)

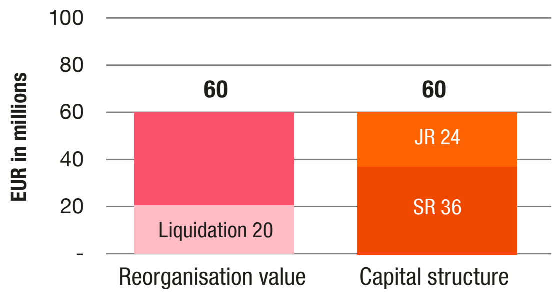
Pre-restructuring



In this example, we go back to the debtor company depicted in Figure 1. The debtor company has a total debt position of EUR 70m (EUR 40m senior, EUR 30m junior). In addition, there is equity of EUR 20m.

As already shown in Figure 1, before the WHOA, the shareholder would be able to use its holdout position and force the junior and senior creditors to take a more significant haircut on their claim compared to their claims' legal ranking.

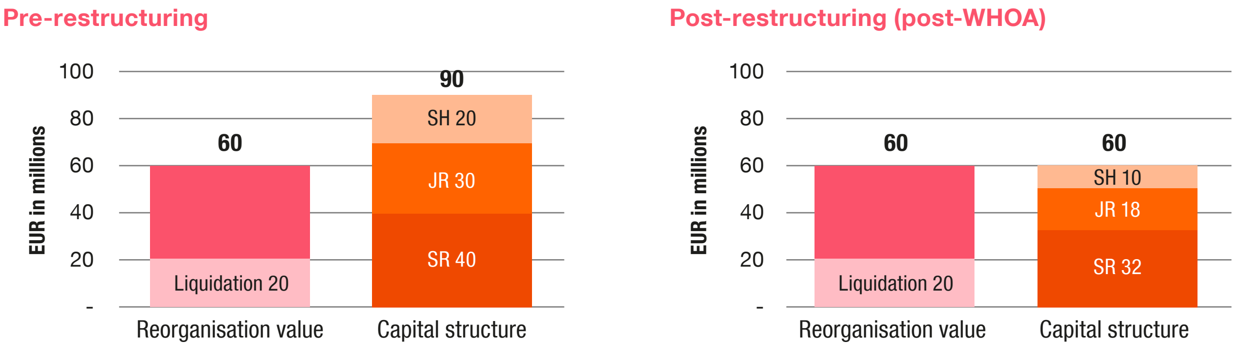
Post-restructuring (post-WHOA)



After the introduction of the WHOA, however, the debtor company (or a restructuring expert on behalf of all stakeholders involved), can propose a restructuring plan whereby (i) the position of the senior creditor, being the highest ranking creditor, marginally changes[1], (ii) the junior converts its debt to equity, and (iii) the current shareholder is pushed out of the capital structure (assuming he did not want to commit additional equity capital). This plan can be sanctioned by the court even against the will of the shareholder.

1 As per an amendment to the draft bill, the secured creditors only have a first claim (in line with their security rights) on the reorganisation value capped at the amount which they would receive in a liquidation scenario. For the remainder of their claim, they rank equal to other unsecured creditors. In our example, the senior creditor has a first claim to the EUR 20m of proceeds (which he would have received under a liquidation) and is then ranked equally to the junior creditor in the distribution of the remainder of the proceeds. As such, of the remaining EUR 40m proceeds they receive 40% or EUR 16m, calculated as 20m (the remainder of their claim) divided by 50m (the sum of this remainder and the claim of the junior creditor of 30m).

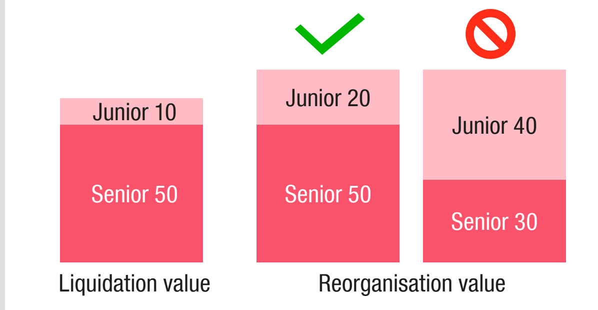
Example 3 Injection of new capital under the WHOA (simplified example)



Let's now assume that EUR 10m of new money is required to realise the reorganisation value of EUR 60m, otherwise the company will go insolvent realising only a value of EUR 20m. However, in the current capital structure, there is no incentive for the shareholder to inject new money unless the junior or senior creditor is willing to write off part of its debt (i.e. the senior and junior have EUR 70m of claims, against EUR 60m of value). With the WHOA, the company can propose a plan where the senior and junior creditors are forced to take a haircut on their loans to allow for an equity injection of the shareholder.[2]

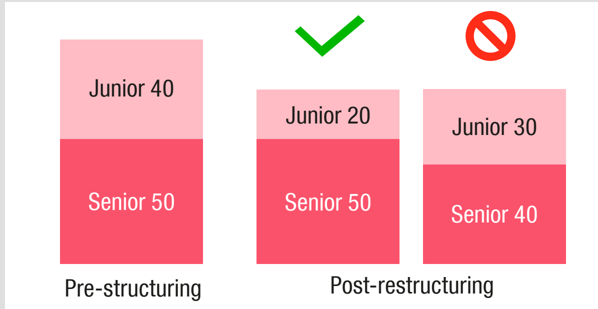
Best interest of creditors

Reorganisation value > liquidation value



Dutch absolute priority rule

Legal ranking should be adhered to



Another example, outlined in ***Example 3***, shows how the WHOA can facilitate the injection of new capital that might be required to successfully implement the restructuring plan. It also shows that the WHOA not only poses a threat to existing shareholders, but also offers significant opportunities.

Given the significant impact the WHOA can have by overruling the fundamental rights of stakeholders their claims, the proposed bill stipulates various safeguards to protect the claims of the shareholders and creditors. The most important safeguards are:

- **Best interest of creditors (for any creditor or shareholder who votes against the plan)**
  A creditor or shareholder should, under the restructuring plan, receive debt or equity instruments which have at least the same value compared to what it would receive in case of an insolvency.
- **Dutch absolute priority rule (for any creditor or shareholder who votes against the plan and is in a class that rejected the plan)**

2 After covering for the EUR 10m new money, EUR 50m of value remains. The senior has a first claim (based on its security position) on EUR 20m of value. The remaining EUR 30m is shared pro rata between the EUR 30m claim of the junior creditor and the remaining EUR 20m claim of the senior creditor.

Under the WHOA, the value distribution should be in line with the economic entitlement of the various parties based on the ranking provided by the law or contract.[3] Any deviation from the ranking is only allowed in exceptional circumstances. Building on the Dutch absolute priority rule, claimants with equal rankings should receive the same value distribution and claimants should not be awarded more than 100% of their claim.

- **Cash-out option (for any creditor who votes against the plan and is in a class that rejected the plan)**
  The plan must allow any creditor that is part of a dissenting class to opt for an immediate cash-out for the amount of its expected recovery if the company were to go bankrupt (i.e. based on the liquidation value). There might be incentives to opt for an immediate cash-out, e.g. in light of the uncertainty of the restructuring plan being successfully executed. The cash-out option cannot be called by secured creditors who are in the business of issuing loans (e.g. banks or debt funds), albeit that these creditors cannot be forced to take equity but also need to be offered an alternative (e.g. extend maturity or change the repayment profile of their loan).

Although the cash-out option serves as an important protective measure for creditors, this could in practice result in unintended holdout positions as there might not be enough liquidity to fund such immediate cash-outs.

Under the reorganisation plan illustrated in ***Examples 2 and 3***, all safeguards are adhered to.

We expect that the WHOA will also have a preventive effect. Parties are likely to adhere to the Dutch absolute priority rule as part of consensual deals more often, knowing this will be a requirement if the consensual deal falls through and a WHOA proceeding is required for implementation. The Dutch absolute priority rule will also increase deal certainty as parties know under which conditions the court will approve the restructuring plan.

3 As aforementioned, the secured creditors only have a first claim (in line with their security rights) on the reorganisation value capped at the amount which they would receive in a liquidation scenario. In the figure illustrating the Dutch absolute priority rule on the previous page, it is for illustrative purposes assumed that the claim of the senior creditor is fully repaid from secured assets in a liquidation scenario.

2. The importance of the reorganisation and liquidation values

With the safeguards as explained above in mind, the reorganisation and liquidation values are clearly the foundation of a restructuring plan under the WHOA. We will briefly touch upon what constitutes these two definitions of value and how these can be estimated.

2.1. Reorganisation value: the value of the company after reorganisation

We define reorganisation value in the context of the WHOA as the value of the company after the restructuring plan has been sanctioned by the court, taking into account any new money to fund this plan and the execution risk of the reorganisation plan. The latter relates to the risk that the implementation of the reorganisation plan is unsuccessful, driven by – for example – adverse market conditions, insufficient quality of the internal organisation and managerial capabilities. It is important to note that this operational risk will not disappear upon the court sanctioning of the restructuring plan; the financial risk associated with a too heavily-levered capital structure, however, will have been resolved.

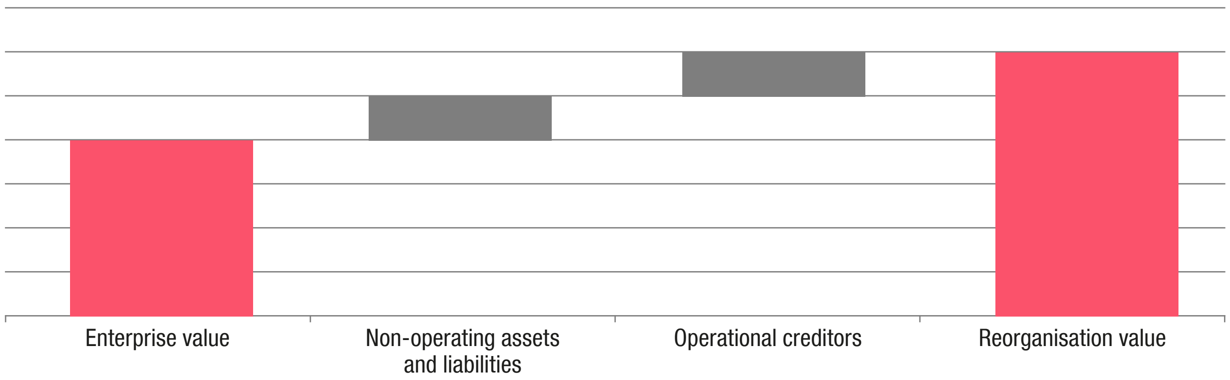
3.1.1. The reorganisation value is an adaptation of the classic enterprise value

The definition of reorganisation value builds on the widely understood concept of enterprise value, i.e. the market value of a business, which is available for providers of equity capital and interest-bearing debt. The most theoretically sound approach to estimate the enterprise value is through the so-called discounted cash flow (DCF) method, which in essence states that the value of a firm is equal to all future cash flows available to debt and equity holders discounted back to today. Further thoughts on the DCF approach (and alternatives) for a valuation under the WHOA are discussed in sections 3.1.2 and 3.1.3.

In addition to the future cash flows, there might also be value in any non-operating assets or liabilities. An example of a non-operating asset is idle land, which is not being used in a company's operations and, hence, not reflected in the company's cash flows. Since this does represent a certain value (the land can be sold), this should be added separately to the enterprise value. An example of a non-operating liability is a long-term environmental liability which has not been factored into the cash flow forecast.

The classic definition of enterprise value holds that it represents the claim that all equity and (interest-bearing) debt providers have on the firm. Under the WHOA, however, operational creditors (e.g. suppliers) might also be claimants as part of the restructuring plan. In order to arrive at the appropriate definition of reorganisation value, one should therefore increase the 'classic' enterprise value (i.e. the discounted value of all cash flows available to debt and equity holders, which assumes payment of any operational creditors) by the claims held by any operational creditors that are part of the plan.

Figure 1 Reorganisation value



3.1.2. A discounted cash flow valuation will likely be the most commonly used approach, using market multiples as sanity check

Enterprise value is most commonly estimated through application of the DCF method, which entails estimating the future free cash flows of the company (typically over a perpetual period, in case the company is valued on a going concern basis) and discounting these to the valuation date using the weighted average cost of capital (WACC, i.e. the weighted return required by debt and equity providers).

The cornerstone for any robust DCF valuation is a well-substantiated business plan and underlying financial projections. This is even more so for the reorganisation value, since the specific impact of resolving the financial distress situation on the operations – such as gradually regaining customer confidence, re-build of inventory and initial unfavourable creditor terms, addressing any backlog capex needs, inclusion of one-off implementation costs for the restructuring, etc. – all need to be taken into account carefully. Key assumptions such as assumed market growth, regaining market share and future profit margin improvements need to be validated and where possible tested based on market studies and benchmarking with peer companies.

An alternative, commonly applied valuation method is the use of multiples, based on either comparable, publicly listed companies or comparable transactions. The observed market prices of the comparable listed companies or transactions are expressed relative to a relevant profit measure (e.g. EBITDA) and the resulting multiple is applied to the maintainable profit of the firm being valued.

We believe that the reorganisation value can typically be best estimated by the discounted cash flow method. Although dependent on various assumptions, this method allows for the incorporation of company-specific elements, which is especially relevant for a company going through a restructuring, which may (for example) require a gradual improvement of working capital ratios over time as well as the inclusion of backlog capex. The use of multiples is greatly dependent on the comparability of the selected transactions and/or listed firms. Especially for a firm going through distress / restructuring, finding suitable comparable peers will be challenging, if not impossible.

Furthermore, simply applying a multiple to the current, depressed earnings level of the debtor firm (which might even be negative) is not reasonable and therefore the use of the multiples method would require the estimation of the company's maintainable earnings as well the correction of the initial multiple-based value for one-off items such as an initial period of lower profits, restructuring costs, backlog capex and working capital investments (in essence then ending up with a hybrid between a 'simple' multiple-based valuation and a DCF valuation).

The use of multiples might prove to be useful when considering the value of the debtor firm after the restructuring plan has been successfully implemented and the company has reached a steady state. Once the debtor firm has successfully executed the restructuring plan, one might expect the implied multiples to be more or less in line with its industry peers. The implied exit multiple of the DCF value some years into the forecast period can therefore be tested by comparing it to market multiples.

3.1.3. Factoring in distress

When factoring in the impact of distress in the valuation of a company, there are two ways to do so: through increasing the required return (WACC) or through adjusting the cash flow projections.

One could reflect the negative impact of distress by increasing the required return (WACC) with a distress premium. This implies that – all else being equal – debt and equity holders require a higher return for firms that are in distress compared to firms that are not. This distress premium – the level of which is very dependent on the specific circumstances and therefore typically quite judgemental – basically reflects there is additional risk associated with the projected cash flows of the debtor firm, as the firm might be heavily impacted by or even go bankrupt as a result of the adverse circumstances.

When estimating the reorganisation value under the WHOA, however, the presumption is that the restructuring plan is sanctioned by the court and, hence, the debtor firm will be relieved of its financial distress and additional capital (if needed) is made available to the company. Depending on the situation, the firm might still be in operational turmoil, but the impact thereof is typically better captured through adjustment of the projected cash flows (e.g. temporarily lower revenues and/or higher cost or investments as explained in the previous section). Reflecting the operational distress in the cash flows also makes assumptions explicit, which is preferred over using a highly judgmental distress premium in the discount factor. Also, the cash flow projections should ideally be subjected to an Independent Business Review (IBR) by a specialised adviser to obtain sufficient comfort on the achievability of these projections and include adjustments to these projections if needed.

3.2. Liquidation value

Liquidation value, in both practice and literature, is traditionally associated with an execution sale of the assets on the balance sheet of the company (e.g. auctioning inventory, machines and furniture, other assets like net working capital or minority participations). However, we believe the concept of liquidation value entails more than that, particularly in the context of the WHOA. In our view, liquidation value comprises the most likely (cash) proceeds that would be realised for the sale of the business (or parts thereof) and/or assets of the company in an insolvency process. This can be realised in various ways: by means of selling the assets separately, by a distressed sale of (parts of) the business activities, or a combination of these approaches (i.e. 'mixed approach').

This broader definition of liquidation value is also consistent with what we see in practice. The Imtech insolvency is a real-life example illustrating that liquidation value entails more than only the execution sale of the assets, as some business activities of Imtech were sold as a whole to a third party (albeit at a discount) and for other parts of the business, a sale of the separate balance sheet assets was executed. All the proceeds together formed the liquidation value of Imtech.

Another well-known example where the sale of business activities was combined with the auction of assets can be found in the insolvency of retailer V&D, where its restaurant activities (La Place) were sold as a going concern, but retail stock sold as separate assets.

The wider definition of liquidation value effectively strengthens the different safeguards of the WHOA and we believe it is in line with the intention of the legislator. The safeguards would be significantly weaker if the legislator would have defined the liquidation value as solely the execution sale of assets. It would lower the threshold to force a reorganisation plan on creditors as the (cash) proceeds realised via a sale of business activities versus an execution sale of the asset can be significantly higher.

This type of liquidation value is, however, inherently more difficult to estimate than the more traditional asset sale-based approach (often based on the use of typical haircuts to different asset classes). This therefore likely requires the involvement of an experienced restructuring adviser, also considering that ultimately not only the liquidation value is needed but also the appropriate apportionment of this value to the different creditors involved. The latter requires careful consideration of any contractual rights of these creditors (pledges, liens, etc.).

4. A multi-stakeholder perspective on valuations under the WHOA

A restructuring process under the WHOA involves a multitude of different stakeholders, each of which might have its own perspective and incentives. A valuation is not merely a calculation exercise, but is driven by often subjective assumptions (which, in turn, are dependent on one's position and incentives). The practical implementation of a valuation under the WHOA is not simply a case of following the theoretical framework outlined in the previous chapter.

On the back of two simplified examples we will illustrate how the WHOA – although having the potential to achieve improved value preservation and a value distribution in line with economic entitlements of the different parties (eliminating hold out position of individual creditors) – will lead to valuation discussions based on each stakeholder's position.

The example outlined on the right assumes a relatively simple capital structure with one (fully secured) senior creditor and one (unsecured) junior creditor. In ***Example 5*** we will introduce the need for new money.

Example 4 Different positions create different views on value

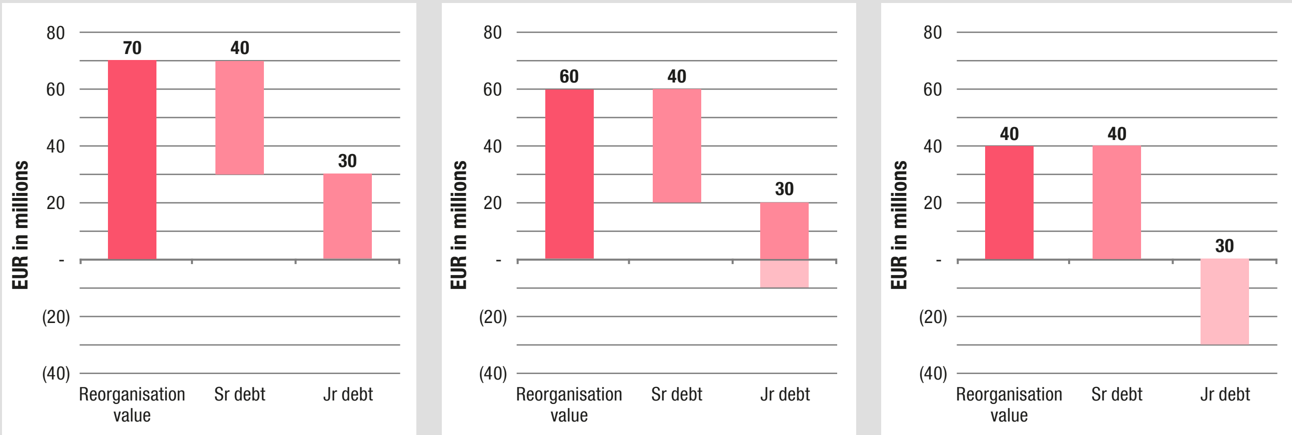
We assume that senior debt holders have a (nominal) value of EUR 40m (fully secured in a liquidation scenario) and junior debt holders have a (nominal) value of EUR 30m (unsecured). The company is in financial distress and stakeholders are discussing what the value of the company after the restructuring would be. The two creditor classes will have different perspectives:

From the senior debt holders' perspective, there is an incentive to argue a lower value. A lower value would increase the chances that the junior debt holders will be (partially) forced out of the envisaged (new) capital structure. This effectively reduces the risk profile of the senior debt holders (i.e. the risk of another future financial distress situation in the future), as the overall claim on the company becomes lower.

From the junior debt holders' perspective, however, the opposite holds true: there is an incentive to argue a higher value. A higher value increases the chances they will not have to write down (part of) their outstanding debt.

To further illustrate this example, we distinguish between three different scenarios:

1. A reorganisation value of EUR 70m, with both the senior and junior creditors in the money.
2. A reorganisation value of EUR 60m, with the senior creditor fully in-the-money, but the junior creditor partially out-of-the-money.
3. A reorganisation value of EUR 40m, with the senior creditor fully in-the-money, but the junior creditor fully out-of-the-money.



In this example, senior debt holders will try to argue an enterprise value below EUR 70m to force the junior creditors to write down part of their outstanding debt, whilst junior creditors will try to argue a value of at least EUR 70m to protect their interest.

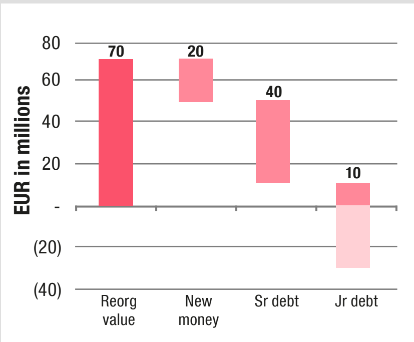
Example 5 The valuation from the perspective of a provider of new money

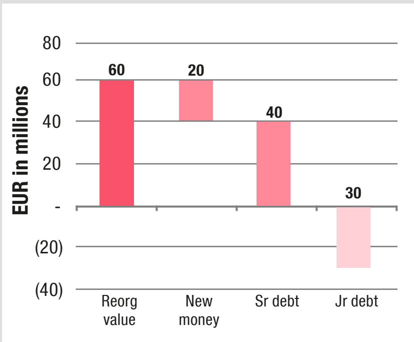
Let's assume that EUR 20m is required to ensure the viability of the restructuring plan and, hence, the debtor firm. The party putting up this new capital, for example the existing shareholder, will have the incentive to argue for a lower valuation.

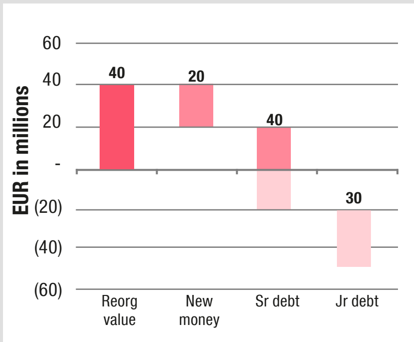
Again, we have three different scenarios:

1. At a reorganisation value of EUR 70m, the senior creditor is fully in the money, whilst the junior debtor has to write off EUR 20m of its claim. The total debt claim on the company is therefore EUR 50m.
2. At a EUR 60m valuation, the junior creditor has to fully write off its claim. The only remaining creditor is the senior with a claim of EUR 40m.
3. If the valuation is argued to be EUR 40m, not only the junior creditor has to fully write off its claim, but also the senior creditor has to write off 50% of its claim.

The shareholder putting up EUR 20m of new money will have an incentive to argue for the lower valuation, since this will further reduce the debt claim that rests on the company. Also, the shareholder's upside potential increases if a lower valuation is argued in case the company outperforms its forecast.







The extent to which these conflicting interests will manifest themselves throughout the restructuring process and as part of the valuation discussions will depend on the degree to which individual creditors are (expected to be) in- or out-of-the-money. This might of course be less of an issue when a creditor has to argue for an unrealistically high valuation in order to be (partially) in the money.

These examples show that, although the WHOA is a big step forward, the valuation process may continue to pose ground for debate, given the various stakeholders' different positions and incentives.

5. Concluding remarks

In pursuit of a better restructuring regime and to preserve value, the WHOA offers a number of advantages when compared to the current restructuring framework in the Netherlands.

- **Putting a stop to holdout positions –** Once the WHOA becomes law, we expect that it will significantly decrease holdout positions in restructuring negotiations and, as such, will improve the chances for survival of the distressed company and the efficiency of the restructuring process.

- **Increased speed of process –** Compared to the current system, the WHOA allows for a significantly faster process. With all parties involved being aware of the possibility of entering into WHOA proceedings, they will tend to set aside their holdout positions and reach an agreement (either under the WHOA or through a consensual agreement).

- **More fertile investment climate –** The outcomes hold value for creditors, shareholder and the employment level at the defaulting company, post restructuring. Thanks to the Dutch absolute priority rule we expect that the distribution of the value will become more in line with economic positions. Therefore, in comparison to the pre-WHOA regime, the overall investment and business climate is expected to thrive better under the WHOA.

This article also outlines some of the challenges that a valuation under the WHOA will bring along. The fact that (i) there are multiple stakeholders at play – each of which likely with their own incentives and views on value, (ii) based on a court-approved restructuring plan, the legal claims of creditors and shareholders can be overruled, (iii) there are specific challenges that come along with valuing a firm in financial and/or operational distress, and (iv) the restructuring process will typically have to be completed in a relatively short timeframe, emphasises the need for involvement of a professional advisor with both valuation and restructuring expertise.

PwC has a large team of highly experienced restructuring and valuation professionals and is ideally positioned to advise companies, creditors, shareholders and courts on the opportunities – but also challenges – stemming from the WHOA.

Overall, we believe that the WHOA provides for a welcome and much needed alternative to the current restructuring framework in the Netherlands, even more so in light of the current COVID-19 crisis. The WHOA provides for an additional instrument for distressed firms and their creditors. If properly implemented, this will not only result in increased value preservation, but also improved value distribution and therefore it benefits the broad set of stakeholders involved in a restructuring process.

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