

Viability opinions

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Be it to validate that a financial decision is made in the interest of the company (“*intérêt social*”) or to attempt to reduce their responsibility in case of litigations, the corporation’s directors must act with prudence and vigilance. This is the case for critical financial decisions such as the recourse to a high level of indebtedness, the split-up of a group or a dividend distribution financed by debt or even for the listing of a subsidiary after distribution of its reserves. This implies that they carry out a certain number of diligences², some of which are in facts too technical to be conducted properly without the assistance of an independent third party expert. An independent financial expert can provide the Board of Directors with an unbiased analysis of the consequences of the transaction as well as support in its final decision making process.

The purpose of the viability opinion

These are some of the reasons for the emergence of “solvency opinions³” in the United States. Delivered to the board of directors and/or to certain creditors, solvency opinions express an opinion that the intended transaction should not prevent the firm’s from fulfilling its obligations to its creditors. One will immediately remark that this concept of solvency is much wider and dynamic than the French solvency concept as in financial matters, we classically define solvency as a company’s ability to face its commitments *in case of liquidation*.

The legal framework of the American practice is the fraudulent conveyance laws which are designed to prevent the shareholders and some creditors from financially benefiting at the expense of other creditors.

A solvency opinion is based on three distinct and complementary analyses, which are legal standards, that address the following questions:

- The “Balance Sheet Test”: Is the value of the company’s operating assets greater than that of its financial debts?
- The “Cash Flow Test”: Can the company meet its liabilities on the contractually agreed maturity dates?
- The “Reasonable Capital Test”: Does the company have sufficient shareholders’ funds to finance its’ planned developments?

¹ Houlihan Lokey is a leading provider in the USA of fairness opinions / solvency opinions.

² “*Le Vade-mecum de l’administrateur*”, pages 77 et seq., Jean-Florent Rérolle and Florian Bressand, IFA, Gualino Editeur, 2005.

³ Also known as “capital adequacy opinion”.

Three positive responses will allow the expert to give the board of directors a favorable opinion on solvency. If the board is the exclusive recipient of opinion, it can nevertheless use it in its relationships to creditors, shareholders or auditors.

These questions partly cover the mission given on July 27, 2006 by the Paris Commercial Court to two independent financial experts at the request of Pages Jaunes with a view to assess *i*) the acceptability for the company's financial structure (...) of an exceptional debt-financed reserves distribution (...) *ii*) the consequences of the contemplated distribution on the company's level of shareholders' funds ; to opine on the adequacy of the debt structure after reserves distribution with the development perspectives anticipated by the company (...) and presented in its business plan.

The road is now open for the emergence of a solvency opinion "*à la française*", which we propose to call "viability opinion". Naturally, since our legal system is different from the American one, the methods used to form this type of opinion will have to be adapted⁴ to deal more precisely with the French context, and to be in line with the concept of social interest ("*intérêt social*"). Building on the American experience and taking into account the expectations of boards of directors' as well as their lawyers' and bankers', we propose to set out the outline of this new tool now available to directors.

Value test⁵

This test requires a valuation of the operating assets of the company, which is then compared to the amount of its financial recorded and latent liabilities. Of the two conceivable alternatives for valuing the company – liquidation or going concern – the second is most frequently adopted as and most logical given the aim of the exercise.

The expert's analytical work is based on the management's business plans and forecasts⁶. In the context of his diligences the expert must check the reasonableness and coherence of the management's forecasts, by comparing them with the assumptions made by financial analysts or industrial experts and / or by carrying out an analysis of the quality of the company's forecasting process (organization, procedure, historical reliability ...).

The valuation exercise is based on a multi-criteria approach. Given the nature of the exercise and above all the methods of the other two tests presented below, the intrinsic method should be given priority. This is the only approach which integrates the full complexity of the financial dynamics of a highly leveraged company: capital expenditures constrained by the financial policy, leverage, tax shield, bankruptcy costs and cost of capital that varies over the forecast period.

⁴ All the more so as since the nature, scope and connections between the various tests still cause significant debate among American lawyers, despite being set forth in the provisions and the case law.

⁵ The denomination of the three tests has been changed with a view to being more representative of the nature of the analyses they would rely on in this French version of solvency opinion.

⁶ Projections must reveal the operating (EBIT, working capital requirements and capital expenditures) and financial (interest charges, debt repayment and dividends) cash flows of the company given the new contemplated capital structure. The forecast period must be long enough to reflect the evolution of the new debt raised for the contemplated transaction.

In this respect, the adjusted present value⁷ is to be considered more particularly. In its simplest form, it consists in discounting enterprise free cash flows at the unlevered cost of equity and to add back the present value of the tax shield. The cash flows to be taken into account should be the "expected" cash flows, or, at least, the most likely ones.

Extrinsic approaches⁸, such as market comparables or transactions relating to similar companies, can be used on a complementary basis in order to support the results obtained by the intrinsic method. Given their methodological shortcomings, they should be used prudently.

The final part of the test involves subtracting the value of the net debt and latent liabilities from the enterprise value. Given that creditors are entitled the total amount of their liability whichever their market value, experts usually take the face value of the debt. The value of potential or contingent liabilities⁹, either adjusted by the probability of their occurrence or at their maximum realistic exposure. If the market value of the company is greater than that of the liabilities, the test is positive.

Liquidity test

The purpose of this test is to check whether the company should be able to pay its interest charges and to repay its debts as they come due. This exercise is based on a precise financing plan of the company provided by the management. Naturally, the projections used in the previous test constitute the basis of this plan. The lines of credit which are likely to be mobilized during the projected period must also be taken into account..

The test is positive if, for each maturity, the company is able to repay its debt as it comes due by using: *i*) the cash flows accumulated over previous periods, *ii*) the cash flows generated during the relevant period, *iii*) available lines of credit and *iv*) potential asset sales.

The company can have an expected cash flow which is greater than the amount of debt to be repaid, while still presenting a significant risk of default. For example, a company whose cash flow forecasts for a given year are 150 (with 10% probability) and 20 (with 90% probability) can repay a debt of 30, since its expected flow is higher (33¹⁰). However, there is a 90% chance that it will default on payment.

Therefore, sensitivity analyses are conducted on the key assumptions which may affect the cash-flows for each maturity date, such as revenue growth, operating margin, working capital requirements or capital expenditures.

The expert may also simulate the impact of down-side scenarios on the company's solvency in order to assess the available equity cushion. The said scenarios are determined in close collaboration with the company's management. Finally, a more sophisticated approach can be used such as a Monte Carlo simulation which, by

⁷ See Myers, S., 1974, "Interactions in Corporate Financing and Investment Decisions – Implications for Capital Budgeting", *Journal of Finance*, (Vol. 29, March), 1-25., and Luehrman, T.A., 1997, "Using APV: A Better Tool for Valuing Operations," *Harvard Business Review*, (May-June), 145-154.

⁸ Extrinsic approaches are also referred to as "analogical" approaches.

⁹ For example environmental or pension provisions.

¹⁰ $33 = 150 \times 10\% + 20 \times 90\%$

simulating the impact of a multitude of random scenarios, enables the measurement of the probability of a payment default.

Financial structure criterion¹¹

The purpose of the last analysis is to appreciate the reasonableness of the company's financial structure post transaction. The contours of the American "reasonable capital test" are often somewhat vague in practice, since it consists, in fact, in opining on the likelihood that the company will default and in making a judgment on the acceptable character of the new capital structure. The difficulty comes not only from the fact that the company can default for reasons which have nothing to do with its leverage but also from the fact that it is difficult to define a precise threshold below which the test is conclusive (5%, 10% or 15% chance of default?), and within which period of time (1 year or more?). It is therefore preferable to speak of a "criterion" rather than of a "test".

In practice, many American experts endeavor to verify whether there is an equity cushion remaining in a downside scenario. However, it seems to us that the identification of a positive "equity cushion" only provides a very partial answer to the question raised and that it may overlap with the other two tests.

In our opinion, the issue is whether the company can take on a significant amount of debt while pursuing its anticipated development perspectives as presented in its business plan¹². This is an important question for the creditors, but also for the shareholders and the employees. It is central to the decision that the directors need to make. Its extreme complexity cannot be addressed by a univocal test. It requires the expert to exercise his professional judgment by using a multi-criteria method, in order to reduce as much as possible the inherent subjectivity of the analysis.

- First, the expert can calculate the company's financial leverage (in terms of fair value) and the various debt coverage ratios given alternative scenarios (possibly by use of such simulation techniques as mentioned above) and then compare them with those of comparable companies. It is then possible to obtain a preliminary indication of whether the contemplated financial structure used is reasonable. However, this approach is not sufficient in itself since it fails to take into account the specific financial dynamics and strategies of each company in the sample, especially since there is little chance that the said sample will contain companies which would recently and significantly have increased their indebtedness.
- He may then perform an intrinsic analysis, the features of which could in our view be inspired by the approach used by credit rating agencies. In fact, a credit rating is indicative of a probability of default and an estimate of a potential subsequent downgrading¹³. The fundamental part of the process consists in determining the nature of the company's operating and financial risk and to appreciate to what

¹¹ We prefer the word "criterion" for this last test as it hardly refers to an absolute numerical conclusion.

¹² By broadening the question to the adequacy of the financial structure to the anticipated business plan, we are departing from the strict standard used in the United States of America.

¹³ Correlation established by the transition matrices published by rating agencies.

extent their conjunction is possible¹⁴. The expert's objective is not the computation of a rating, but this analytical analysis could prove very useful as it is similar to the approach of the valuation of the company as effected for the value test¹⁵.

- Other additional elements can be considered in this analysis: the intentions or commitments of the managers with regard to financial policy (debt repayment schedule, dividend policy), the financial commitments, strategy and surface of the controlling shareholders and finally the consolidation dynamics in the industry which may imply a strategic necessity to grow by acquisition or facilitate the disposal of all or part of the business).

Based on these analyses¹⁶ the expert's role is to provide an opinion on the reasonableness of the foreseen financial structure.

An integrated and complex process

The sequential presentation of the two tests of value and liquidity and of the financial structure criterion must not conceal an essential factor: the fact that all these analyses are necessarily integrated. They are in fact all based on the same business plan, on the same projections and on the same alternative scenarios. The work carried out in connection with one of the tests will often be used in the others. The study of operating and financial risks, conducted in the financial structure analysis, provides indications on the appropriate discount rate and how to take into account the specific risk in the value test. The investment strategy or the working capital requirements are key factors in the calculation of the company's value and in the liquidity test.

The advantage of combining these three tests does not lie in the assumptions or techniques they employ, but in their respective perspectives, as illustrated by the sensitivity analyses which are conducted: in the value test they are used to determine a value-range, in the solvency test they enable the scenarios to be pushed to their limits and in the financial structure criterion, they help the expert identify the key factors relating to the operating and financial risk.

At the end of the day, the methodological set of tools used in a viability opinion is not very different from that used in a valuation. However, it is often a more complex exercise, since it involves difficulties which are rarely encountered by most valuation professionals. The combined analysis of the operational and financial risk requires more extensive diligences, experience of often sophisticated financial modeling and simulation techniques and an even more rigorous handling of the discount rate.

¹⁴See "Corporate Rating Criteria", Standard & Poor's, 2006.

¹⁵ For a comparison of the rating and valuation methods, see "*Ne tirez pas sur les agences de rating!* [Don't shoot the rating agencies!]", Jean-Florent Rérolle, Banque et Stratégie n°203, April 2003.

¹⁶ Other analyses, more theoretical or even complex are conceivable like for example the use of an options' approach. (See "Finance d'entreprise et théorie des options", P. Navatte, Economica, 1998) or the use of tools such as the Value-at-Risk or the Cash-Flow-at-Risk (See: "Exposure-Based Cash-Flow-at-Risk : an alternative to VaR for industrial companies", N. André, H. Jankens, L. Oxelheim, Journal of Applied Corporate Finance, Vol 17 Number 3, Summer 2005).

Opportunities and Threats of the viability opinion

Delivering a viability opinion obviously puts the expert at risk. He can lessen it first by the rigor and professionalism of his analysis. One could not insist too much on the level of complexity of the works required for these tests. The financial expert must be well-versed in sophisticated financial valuation techniques. He must also have a strong experience in restructuring in order to assess the risk of insolvency correctly as it has a clear impact on the value of a highly leveraged company.

The depth of the analysis produced in a viability opinion makes it easier to understand the benefit it provides for the directors. Hiring an independent financial expert enables the board to show that it obtained an unbiased analytical viewpoint before taking a particularly delicate decision which might be potentially dangerous for the company, its shareholders, creditors and employees.

Second, the expert must also ensure that his engagement letter comprises all the standard indemnification and hold harmless provisions¹⁷. In fact his mission does not consist in guarantying the solvability or viability of the company but in providing the board of directors with a specialist's opinion clarifying a complex financial situation.

Being handled by an independent financial expert, the viability opinion for and foremost provides the board with an unbiased analysis capacity before making a particularly sensitive decision regarding the company, its shareholders, creditors and employees. But even if it helps the directors prove that they did not act inconsiderately, the existence of a viability opinion alone can not exonerate them of their responsibilities.

As a whole, the viability opinion is a corporate governance and good management tool : it improves the directors' level of information, enables an effective debate within the board and between the directors and the management; it improves the decision-making process by introducing a fresh point of view on the intended transaction. It's better to ensure that a decision is based on sound elements before hands rather than to be forced to justify it in front of a judge afterwards. For all these reasons, boards should be encouraged to rely on this type of opinions when a critical financial decision is contemplated.

The views set out herein represent solely the views of the author and not necessarily those of Houlihan Lokey. The content of this article does not constitute financial or other advice and should not be relied upon as such.

¹⁷ A viability opinion can only be valid for a certain period of time. It relies on projections which reflect the management's best estimates at the time of the analysis and the effective realization of the business plan may substantially differ from the initial forecasts.