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Bankruptcy and Difficult Valuation Issues: Allocation, Intangibles, Contingent Assets

Strategies for Secured Creditors

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Bankruptcy and Difficult Valuation Issues

Allocation, Intangibles, Contingent Assets, & NFTs

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What we will discuss today

- Why Valuation Matters?
- Key Junctures for Valuation in a Bankruptcy Case
- Valuation Methodologies
- Specific Types of Hard to Value Assets
  - Causes of action, IP/NFTs, Intangible Assets, Contingent Assets & Future Company Value
- Strategies for Selecting Valuation Experts

Why Valuation Matters?

Valuation can be the biggest driver of outcomes in a case, and is often hotly disputed.

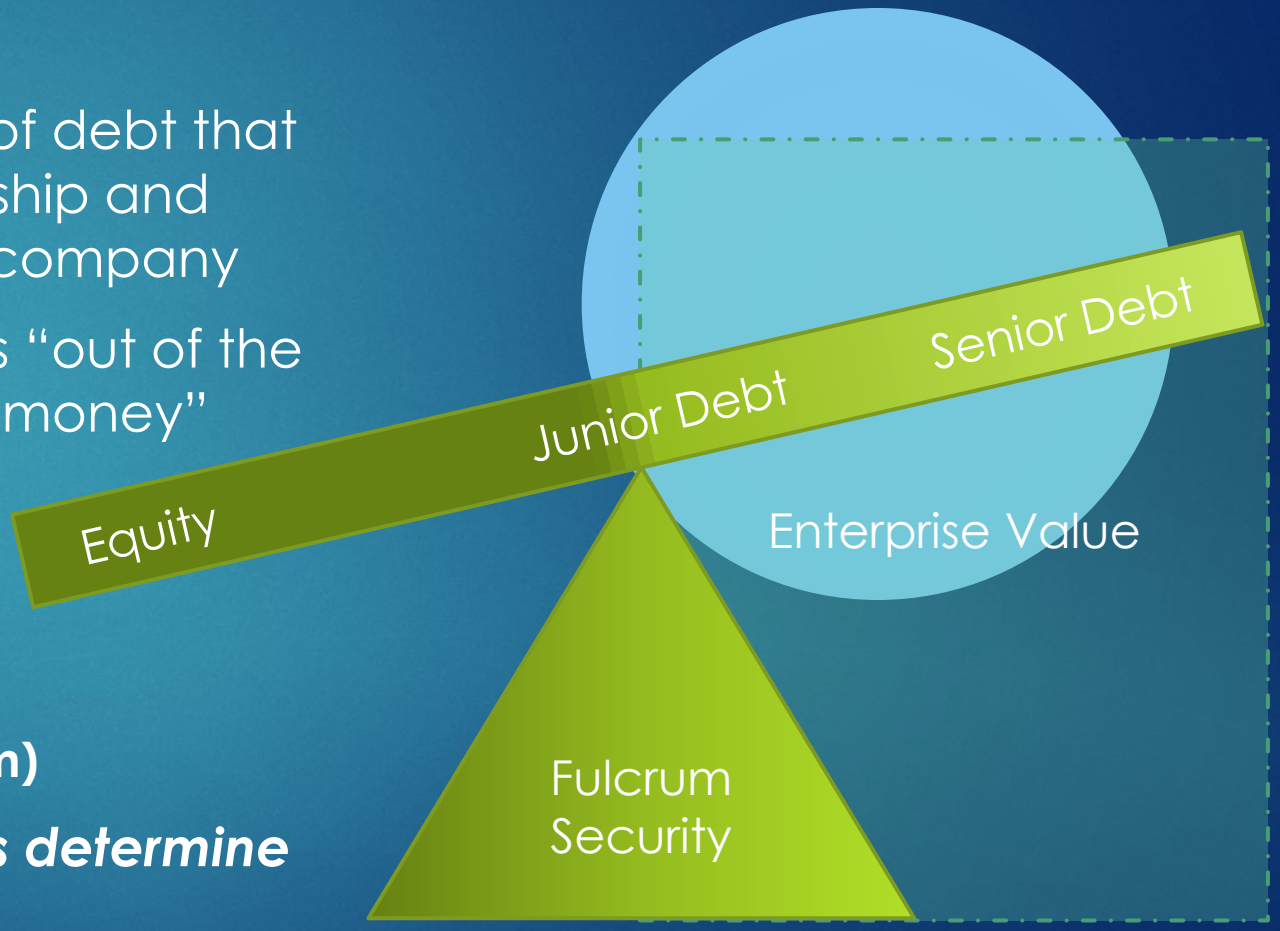
- Parties-in-interest recoveries driven by value available for distribution
- Understanding valuation and the "fulcrum security" provides leverage in the conference room and in the courtroom.
- The valuation exercise is highly subjective and "reasonable minds can and often do disagree."
- Financial models are driven by their inputs, many of which are subjective in nature. It has been described by courts as a "guess compounded by an estimate."

Valuation disputes become a mini-battle of experts, their valuation methodologies, the reasonableness of their assumptions and their relative credibility.

Counsel must assist judges in valuing not only companies, collateral, and securities but may other types of unusual, complex, and hard-to-value assets.

Fulcrum Security – What is it and Why Does it Matter?

- The fulcrum security is the tranche of debt that will likely convert into equity ownership and ultimately control the reorganized company
- Debt junior to the fulcrum security is "out of the money" while senior debt is "in the money"
- Example:
  - Debtor enterprise value of $100m
  - Senior Debt claim for $80m
  - Junior Debt claims of $40m **(Fulcrum)**
- ***So how do investment professionals determine where the fulcrum sits?***



Key Junctures for Valuation in a Bankruptcy Case

Valuations are done for different purposes in the context of a single bankruptcy case. The most common valuation contexts include:

- Plan Confirmation: Best interests test, permissibility of cram down, and other requisites of Plan confirmation
- Priming DIP and Use of Cash Collateral: Valuation of collateral of prepetition secured debt, which is critical for assessing whether such secured debt can be involuntarily primed by other lenders' DIP loans, what usage of cash collateral is permitted, and what postpetition interest and other adequate protection measures are due.
- Assessing the fairness and sufficiency of consideration for proposed 363 sales, settlements, or other non-Plan transactions involving tangible assets or going-concern businesses of a debtor.
- Automatic stay relief
- Solvency Litigation
  - Fraudulent Transfer Litigation
  - Breach of Fiduciary Duty Litigation
  - Recharacterization Litigation
  - Equity Committee Formation

Valuation: Plan Confirmation

- Valuation drives Plan negotiations because the value of a reorganized debtor determines the distribution of value (whether cash, debt or new equity) among stakeholders.
- Valuation is relevant to confirmation of a contested plan.

"Cram Down"

- Confirming a plan where one impaired class rejects the plan. 11 U.S.C §1129(b)
- Enterprise valuation may be necessary to determine whether senior creditors are receiving distributions in excess of their allowed claims to the detriment of junior stakeholders (subordinated debt or equity)
- To be "fair and equitable" (i.e. satisfy absolute priority) a creditor cannot be paid more than full compensation for its claim

"Best Interests Test"

- When there are minority dissenting creditors in a class that votes to accept the plan, the plan proponent must demonstrate that the plan provides dissenting creditors with a distribution equal to at least as much as what such creditors would receive in a hypothetical liquidation
- The "best interests test" requires an enterprise valuation showing creditor distributions under a liquidation scenario

Valuation: treatment of prepetition secured debt

- Secured creditors are entitled to "adequate protection" against the erosion in their collateral value. Valuation is relevant to confirmation of a contested plan.
- A common type of collateral value erosion arises from the (i) incurrence of senior debt due to approval of a priming or *pro rata* post petition loan or (ii) non-consensual use of cash collateral.
- While "adequate protection" is not defined in the Code, section 361 provides three examples of adequate protection, including

  (i) requiring the debtors to make periodic cash payments to the extent of the decrease in collateral value,

  (ii) providing an additional or replacement lien to the extent of the decrease in collateral value, or

  (iii) granting other relief that will result in the "indubitable equivalent" of the interest in the collateral

Valuation: treatment of prepetition secured debt (equity cushion)

- Entitlement to adequate protection often requires a valuation of a secured creditor's collateral to determine whether the creditor is sufficiently protected with an equity cushion.
- An equity cushion exists when the value of the collateral exceeds value of the secured claim. Thus, a valuation of the collateral is required to determine the existence and size of the equity cushion.
- The equity cushion is generally expressed as a percentage of the secured debt to be primed.
- For example, if the secured claim is $100 million and the collateral is worth $150 million, the equity cushion is 50 percent.
- There is no bright-line test for the size of the equity cushion, but courts have generally held a roughly 20-percent cushion (after giving effect to the incurrence of the Priming DIP Loan) to be sufficient, and anything below 10 percent to be insufficient.

Valuation: treatment of prepetition debt (postpetition interest)

- Secured creditors can receive post-petition interest and fees when the value of the collateral exceeds the value of the claim amount. *See* 11 U.S.C. § 506(b).
  - Valuation of collateral is therefore necessary to determine whether a secured creditor is over-secured (*i.e.*, collateral value exceeds claim amount).
- In some cases, unsecured creditors can recovery post-petition interest where debtor is solvent.
  - Enterprise valuation to demonstrate solvency may be necessary.

Valuation: Automatic Stay Relief

- A creditor can seek relief from the automatic stay for "cause," which includes a lack of adequate protection.
- Courts will often require showing of the diminution in the value of the collateral as of the time the case was filed.
  - This may require, among other things, a measure of the collateral, the amount the collateral has declined in value, and a showing that the equity cushion is insufficient to protect against the diminution in value.
- Stay relief may also be granted where the debtor has no equity in the collateral and the collateral is not necessary for an effective reorganization.

Valuation: Historical Insolvency

- Valuation is relevant to establish the debtor's insolvency in connection with several bankruptcy-related claims.
  - *Avoidable Preferences.* Requires a demonstration of insolvency along with satisfaction of other tests; insolvency is (rebuttably) presumed in the 90 days prepetition.
  - *Constructive Fraudulent Transfer.*
    - *Need to show "reasonably equivalent value" and "insolvency" at time of transaction*
  - *Breach of Fiduciary Duty*
    - Valuation to determine the debtor's solvency at the time of the challenged board decision is relevant because fiduciary duties (at least under Delaware law) expand to include creditors only after the company becomes insolvent
  - *Recharacterization*
    - Recharacterization is an equitable remedy that allows a court to recharacterize a debt instrument as an equity investment. Valuation is relevant because most courts apply a multi-factor test, which includes an assessment of the debtor's solvency and financial condition at the time of transaction to determine whether an investment should be considered equity.

Valuation: Equity Committee Formation

- Solvency is also a factor considered by courts in connection with the appointment of an official committee of equity securities holders under section 1102(a) of the Bankruptcy Code
- Unlike official committees of unsecured creditors, which do not need to demonstrate a strong prospect of an unsecured recovery to be formed, Bankruptcy Judges and United States Trustees require proponents of the formation of official committees of equity security holders to show a strong possibility that the realizable value of all assets available to an estate will exceed the amount of the allowable claims against the estate.

Operating Premise of Value

- The valuation exercise requires an important threshold decision as to whether the company should be valued on a "going concern" basis or a liquidation basis.
- Many valuation exercises benefit from consideration of both bases.
- This threshold decision has a significant impact on the valuation conclusion. With the exception of a valuation done to determine compliance with the best interests test in connection with plan confirmation (described above), the operational premise of value usually depends on the operational status of the debtor at the time of the valuation.
- If liquidation was not "clearly imminent" on the relevant measurement date, then the entity should be valued as a going concern. *See Moody v. Sec. Pac. Bus. Credit, Inc.*, 971 F.2d 1056, 1067 (3d Cir. 1992); *In re Taxman Clothing Co.*, 905 F.2d 166, 169–70 (7th Cir. 1990) (going concern valuation is proper unless business was "on its deathbed").

Valuation Overview

- Value Drivers
- Valuation Approaches
- Intangible Assets Valuation Methodology
- Illustrative Example
- Analytical Issues in Bankruptcy Valuation

"Price is what you pay. Value is what you get."

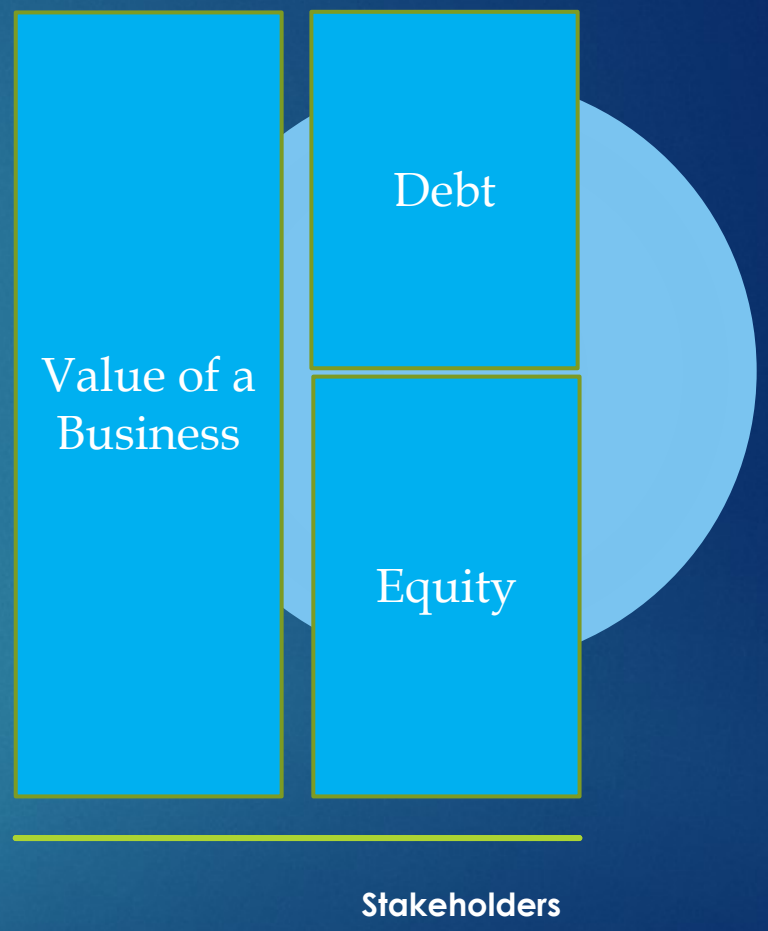
- Warren Buffett

Reasons to conduct a bankruptcy valuation

- Preference actions solvency analysis (Section 547)
- Fraudulent transfers solvency analysis (Section 548)
- Asset sale prices and creditors adequate protection (Section 363)
- Adequate protection of creditor's interest (Section 361)
- Value of secured creditor's claim as fully secured (Rules 3012 and 3018)
- Confirmation of the reorganization plan (Section 1129)
- Cram down of the reorganization plan (Section 1129)
- Secured creditor relief from the automatic stay (Section 362)
- Collateral value of the debtor-in-possession (DIP) financing
- Director duties and zone of insolvency

Value Drivers

- Cash flows – future expected cash flows
  - Risk | Uncertainty
- Growth expectations
- Assets
  - Operating Assets: working capital, property, plant & equipment, intangible assets
  - Intangible Assets – competitive advantage (cost savings, barriers to entry, enhance revenues)
  - Non-Operating Assets
    - Investments, excess cash, real estate, etc.



Valuation Approaches

Income Approach	Market Approach	Cost or Asset Approach	Hybrid
Capitalization of Earnings Method Discounted Cash Flow Method	Guideline Public Company Method Merged & Acquired Company Method	Adjusted Net Asset Value	Excess Earnings Method

Intangible Assets Valuation

Business Enterprise Value

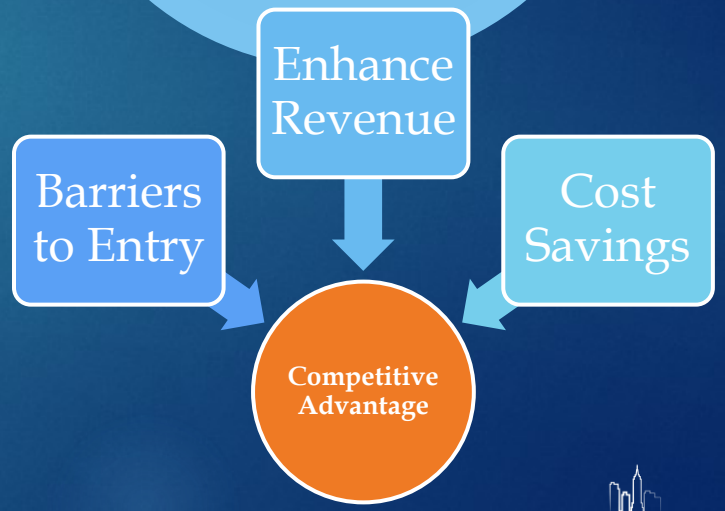
Allocates to:

- Tangible Assets
- Intangible Assets
- Goodwill

Intangible Assets

- Trade Name
- Patents
- Technology
- Licensing Agreements
- Assembled Workforce
- Customer Relationships
- Non-Compete Agreements

Intangible Assets	
Arising from Contractual or Legal Rights Marketing-based Customer-related Artistic-related Contract-based Technology-based	**Goodwill** Not Amortized, Tested Annually for Impairment



Definition of “Intellectual Property"

Section 101, subsection 35A provides the following definition of intellectual property:

(35A) The term “intellectual property” means –

(A) trade secret;
(B) invention, process, design, or plant protected under title 35;
(C) patent application
(D) plant variety;
(E) work of authorship protected under title 17; or
(F) mask work protected under chapter 9 of title 17.

- The financially distressed DIP usually doesn’t have a lot of property left to pledge for DIP financing collateral (i.e., the debtor company has already pledged AR, inventory, real estate, etc.).
- The DIP financing may involve the pledge of the debtor company’s intellectual property assets as the DIP financing collateral.

Intangible Asset Valuation

Methodologies

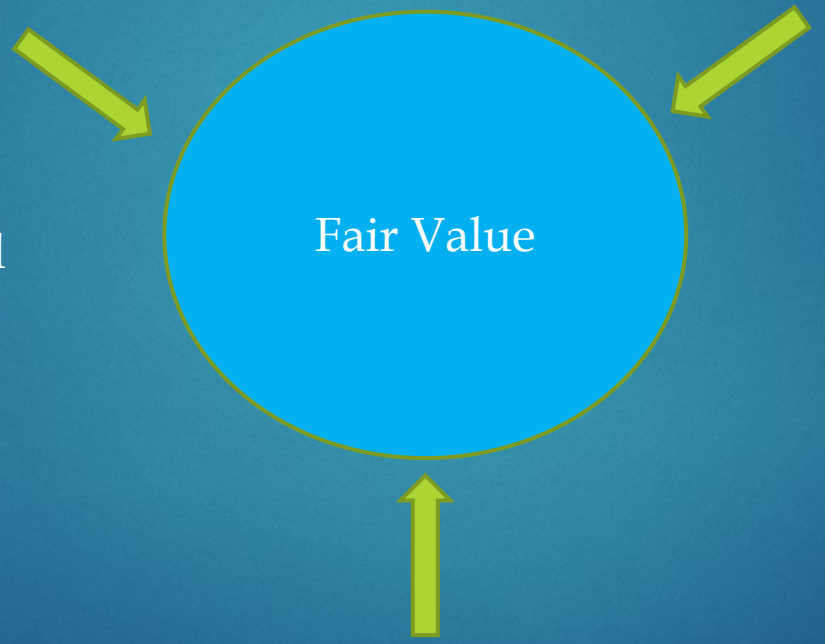
Intangible Assets: Valuation Approaches

Income Approach
Based on the PV of expected future earnings or cash flows to be derived from ownership of the asset

Methodologies
- Excess Earnings
- Relief from Royalty
- With-and-Without Method

Cost Approach
Based on the cost to reproduce or replace the asset

Methodologies
- Historical or replacement Cost



Market Approach Based on transactions involving the sale or license of similar intangible assets in the marketplace

Relief from Royalty

Description

Determined value by reference to the hypothetical royalty payments that would be saved through owning the asset, as compared with licensing the asset from a third party.

Frequent Applications

- Brand | Trade Name
- Technology
- Patents
- NFTs, etc.

Key Inputs

1. Revenue forecast associated with the intangible asset being valued
2. Expected remaining useful life
3. Applicable royalty rate
4. Discount rate

$$FV = \underset{4}{PV(r)} \sum_{t=0}^{\overset{2}{t}} \left(\overset{1}{\text{Revenue}} \times \underset{3}{\text{Royalty}} (1 - \text{tax}) \right)$$

Excess Earnings

Description

The present value of the earnings attributable to the subject intangible asset after pricing for the proportion of the earnings that attribute to return for contributory assets.

Frequent Applications

- Customer relationships
- IPR&D
- Technology

Key Inputs

1. Applicable revenue forecast
2. Applicable expenses
3. Contributory asset charges ("CAC")
4. Tax rate
5. Expected remaining useful life
6. Discount rate

$$FV = PV(r) \sum_{t=0}^{t} \left(\text{Revenue} - \text{Expenses} - \text{CAC's} - \text{Taxes} \right)$$

Cost

Description

Estimates the fair value of an asset by approximating its depreciation replacement cost, which would include all costs necessary to construct a similar asset of equivalent utility at prices applicable at the time of reconstruction.

Key Inputs

1. All hypothetical costs that are needed to recreate the asset including material and labor
2. Adjustment factors to reduce the replacement cost to the functional, economic and technological condition of the subject asset

Frequent Applications

- Technology (e.g., internally-generated software)
- Formulations
- Workforce

1. Replacement Cost New
2. – Obsolescence Factors

With and Without

Description

Estimates the fair value of an asset by comparing the value of the business inclusive of the asset to the hypothetical value of the same business excluding the asset.

Frequent Applications

- Contracts
- Non-competition agreements
- Processes and technologies

Key Inputs

1. Cash flow forecast "with" asset
2. Discount rate
3. Expected useful life (term)
4. Cash flow forecast "without" asset
5. Discount rate
6. Term

$$FV = PV_1(r) \sum_{t=0}^{t} \left(\text{Revenue} - \text{Expenses} - \text{CapEx/WC} - \text{Taxes} \right) - PV_2(r) \sum_{t=0}^{t} \left(\text{Revenue} - \text{Expenses} - \text{CapEx/WC} - \text{Taxes} \right)$$

Illustrative Example

Great Courses LLC

Forecast	Assumptions	2021	2022	2023	2024	2025	Terminal Value
Revenues							
Subscription (Regular)		$ 945,000	$ 992,000	$ 1,042,000	$ 1,094,000	$ 1,149,000	$ 1,206,000
On-Demand		71,000	99,000	104,000	109,000	115,000	121,000
Revenue		**$ 1,016,000**	**$ 1,091,000**	**$ 1,146,000**	**$ 1,203,000**	**$ 1,264,000**	**$ 1,327,000**
Revenues Growth Rate %			*7.4%*	*5.0%*	*5.0%*	*5.1%*	*5.0%*
Cost of Revenue							
Subscription (Regular)		520,000	546,000	573,000	602,000	632,000	663,000
On-Demand		30,000	30,000	30,000	35,000	35,000	35,000
Cost of Revenue		550,000	576,000	603,000	637,000	667,000	698,000
Gross Profit		**$ 466,000**	**$ 515,000**	**$ 543,000**	**$ 566,000**	**$ 597,000**	**$ 629,000**
Gross Profit Margin %		*45.9%*	*47.2%*	*47.4%*	*47.0%*	*47.2%*	*47.4%*
Admin		100,000	103,000	105,000	108,000	110,000	113,000
R&D		12,000	12,000	13,000	13,000	13,000	14,000
S&M		137,000	140,000	144,000	148,000	151,000	155,000
G&A		25,000	26,000	26,000	27,000	28,000	28,000
Total Operating Expenses		**274,000**	**281,000**	**288,000**	**296,000**	**302,000**	**310,000**
EBITDA		**$ 192,000**	**$ 234,000**	**$ 255,000**	**$ 270,000**	**$ 295,000**	**$ 319,000**
EBITDA Margin %		*18.9%*	*21.4%*	*22.3%*	*22.4%*	*23.3%*	*24.0%*
Depreciation		98,000	98,000	98,000	99,000	99,000	99,000
EBIT		**$ 94,000**	**$ 136,000**	**$ 157,000**	**$ 171,000**	**$ 196,000**	**$ 220,000**
Taxes	*35.0%*	32,900	47,600	54,950	59,850	68,600	77,000
After-Tax Net Income		**$ 61,100**	**$ 88,400**	**$ 102,050**	**$ 111,150**	**$ 127,400**	**$ 143,000**
Plus: Depreciation		98,000	98,000	98,000	99,000	99,000	99,000
Less: Incr. in Net Working Capital	*8.0%*	6,000	6,000	4,400	4,560	4,880	5,040
Less: CAPEX		100,000	100,000	100,000	100,000	100,000	100,000
Net Cash Flow		**$ 53,100**	**$ 80,400**	**$ 95,650**	**$ 105,590**	**$ 121,520**	**$ 136,960**
Long-Term Growth Rate	*2.5%*						
Discount Rate	*12.0%*						
Terminal Value							**$ 1,441,684**
Period		0.5	1.5	2.5	3.5	4.5	4.5
PV Factor		0.9	0.8	0.8	0.7	0.6	0.6
Present Value of Cash Flows		**$ 49,914**	**$ 67,536**	**$ 71,738**	**$ 70,745**	**$ 72,912**	**$ 865,011**
Enterprise Value	**$ 1,197,855**						

Intangible Assets:

- Tradename
- Customer Relationships
- Technology
- Goodwill

Tradename

Relief-from-Royalty	Assumptions	2021	2022	2023	2024	2025	Terminal Value
Revenue		$ 1,016,000	$ 1,091,000	$ 1,146,000	$ 1,203,000	$ 1,264,000	$ 1,327,000
Royalty Rate	*3.5%*	*3.5%*	*3.5%*	*3.5%*	*3.5%*	*3.5%*	*3.5%*
Royalty Savings		**$ 35,560**	**$ 38,185**	**$ 40,110**	**$ 42,105**	**$ 44,240**	**$ 46,445**
Taxes	*35.0%*	12,446	13,365	14,039	14,737	15,484	16,256
After-Tax Royalty Savings		**$ 23,114**	**$ 24,820**	**$ 26,072**	**$ 27,368**	**$ 28,756**	**$ 30,189**
Long-Term Growth Rate	*2.5%*						
Discount Rate	*16.5%*						
Terminal Value							**$ 215,638**
Period		0.5	1.5	2.5	3.5	4.5	4.5
PV Factor		0.9	0.8	0.7	0.6	0.5	0.5
Present Value of Cash Flows		**$ 21,496**	**$ 19,856**	**$ 17,729**	**$ 16,421**	**$ 14,378**	**$ 107,819**

Tradename Fair Value	**$ 197,699**

Customer Relationships

Excess Earnings	Assumptions	2021	2022	2023	2024	2025	2026
Revenue		$ 945,000	$ 992,000	$ 1,042,000	$ 1,094,000	$ 1,149,000	$ 1,206,000
Customer Erosion	*20.0%*	80.0%	64.0%	51.2%	41.0%	32.8%	26.2%
Existing Customer Relationships Revenue		**$ 756,000**	**$ 634,880**	**$ 533,504**	**$ 448,102**	**$ 376,504**	**$ 316,146**
Cost of Revenue		440,000	368,640	308,736	260,915	218,563	182,977
Admin		74,000	60,000	49,000	40,000	33,000	27,000
G&A		19,000	15,000	12,000	10,000	8,000	7,000
Subtotal		533,000	443,640	369,736	310,915	259,563	216,977
EBITDA		**$ 223,000**	**$ 191,240**	**$ 163,768**	**$ 137,187**	**$ 116,942**	**$ 99,169**
Depreciation		72,921	57,029	45,623	36,876	29,489	23,586
EBIT		**$ 150,079**	**$ 134,211**	**$ 118,145**	**$ 100,311**	**$ 87,453**	**$ 75,583**
Taxes	*35.0%*	52,528	46,974	41,351	35,109	30,609	26,454
Contributory Asset Charges							
Fixed Assets	*3.3%*	25,229	21,187	17,804	14,954	12,564	10,550
Tradename	*2.3%*	17,199	14,444	12,137	10,194	8,565	7,192
Working Capital	*0.7%*	5,343	4,487	3,770	3,167	2,661	2,234
License	*0.8%*	6,048	5,079	4,268	3,585	3,012	2,529
Workforce	*0.3%*	2,268	1,905	1,601	1,344	1,130	948
Total		56,087	47,101	39,580	33,244	27,932	23,454
Subtotal		**41,465**	**40,137**	**37,215**	**31,958**	**28,912**	**25,675**
Discount Rate	*15.0%*						
Period		0.5	1.5	2.5	3.5	4.5	4.5
PV Factor		0.9	0.8	0.7	0.6	0.5	0.5
Present Value of Cash Flows		**$ 38,562**	**$ 32,511**	**$ 26,422**	**$ 19,494**	**$ 14,456**	**$ 12,837**
Customer Relationships Fair Value	**$ 144,283**						

Contributory Asset Charges	Assumptions	2021	2022	2023	2024	2025	Residual
Opening PP&E		$ 438,000	$ 440,000	$ 442,000	$ 444,000	$ 445,000	$ 446,000
CAPEX		100,000	100,000	100,000	100,000	100,000	100,000
Depreciation		98,000	98,000	98,000	99,000	99,000	99,000
Ending PP&E		440,000	442,000	444,000	445,000	446,000	447,000
Return on	*8.0%*	35,200	35,360	35,520	35,600	35,680	35,760
Revenues		$ 945,000	$ 992,000	$ 1,042,000	$ 1,094,000	$ 1,149,000	$ 1,206,000
CAC - PP&E	*3.3%*	**3.7%**	**3.6%**	**3.4%**	**3.3%**	**3.1%**	**3.0%**
Opening Working Capital		76,000	82,000	88,000	92,400	96,960	101,840
Change		6,000	6,000	4,400	4,560	4,880	5,040
Ending Working Capital		82,000	88,000	92,400	96,960	101,840	106,880
Return on	*8.0%*	6,560	7,040	7,392	7,757	8,147	8,550
Revenues		$ 945,000	$ 992,000	$ 1,042,000	$ 1,094,000	$ 1,149,000	$ 1,206,000
CAC - Working Capital	*0.7%*	**0.7%**	**0.7%**	**0.7%**	**0.7%**	**0.7%**	**0.7%**
Tradename Pre-Tax	*3.5%*						
Tradename After-Tax Royalty Rate	*2.3%*						

Technology

With and Without	Assumptions	2021	2022	2023	2024	2025	Residual
Revenue							
Subscription (Regular)		$ 945,000	$ 992,000	$ 1,042,000	$ 1,094,000	$ 1,149,000	
On-Demand		-	-	-	55,000	86,000	
Revenues		**$ 945,000**	**$ 992,000**	**$ 1,042,000**	**$ 1,149,000**	**$ 1,235,000**	
Cost of Revenue		520,000	546,000	573,000	637,000	667,000	
Admin		93,000	93,000	96,000	103,000	108,000	
S&M		127,000	128,000	131,000	141,000	148,000	
G&A		23,000	23,000	24,000	26,000	27,000	
R&D		20,000	20,000	20,000	13,000	13,000	
Total		783,000	810,000	844,000	920,000	963,000	
EBITDA		**$ 162,000**	**$ 182,000**	**$ 198,000**	**$ 229,000**	**$ 272,000**	
Depreciation		98,000	98,000	98,000	99,000	99,000	
EBIT		**$ 64,000**	**$ 84,000**	**$ 100,000**	**$ 130,000**	**$ 173,000**	
Taxes	*35.0%*	22,400	29,400	35,000	45,500	60,550	
After-Tax Earnings		**$ 41,600**	**$ 54,600**	**$ 65,000**	**$ 84,500**	**$ 112,450**	
Depreciation		98,000	98,000	98,000	99,000	99,000	
Capital Expenditures		100,000	100,000	100,000	100,000	100,000	
Working Capital		4,000	4,000	4,000	9,000	7,000	
Subtotal		**35,600**	**48,600**	**59,000**	**74,500**	**104,450**	
Terminal Value							**1,441,684**
Discount Rate	*13.5%*						
Period		0.5	1.5	2.5	3.5	4.5	
PV Factor		0.9	0.8	0.7	0.6	0.6	
Present Value of Cash Flows		**$ 33,464**	**$ 40,338**	**$ 43,070**	**$ 47,680**	**$ 865,011**	
Without Technology (Subscriptions) Fair Value	**$ 1,029,563**						
Enterprise Value with Technology	**$ 1,197,855**						
Technology Fair Value	**$ 168,293**						

Workforce - Replacement Cost

Workforce - Level	# of FTEs	Avg. Salary	Recruitment Cost % of Salary	Recruitment Cost per FTE	Training Period (Unproductive - Months)	Training Cost per FTE	Replacement Cost per FTE	Total Replacement Cost
Operations	1.00	$ 50,000	5%	$ 2,500	1.5	$ 10,000	$ 12,500	$ 12,500
R&D	0.50	$ 75,000	10%	$ 7,500	3.0	$ 19,000	$ 26,500	$ 13,250
S&M	1.00	$ 60,000	5%	$ 3,000	1.5	$ 11,000	$ 14,000	$ 14,000
G&A	2.00	$ 150,000	10%	$ 15,000	3.0	$ 50,000	$ 65,000	$ 130,000
Total	**4.50**					**Workforce Indicated Value**		**$ 169,750**

Summary	
Enterprise Value	**$ 1,197,855**
Tangible Assets	**500,000**
Intangible Assets	**$ 697,855**

Intangible Assets

1. Tradename
2. Customer Relationships
4. Technology
5. Goodwill

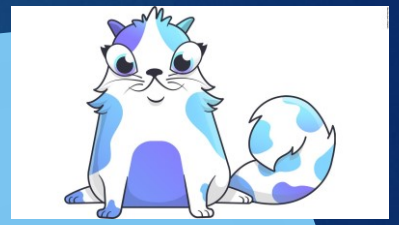
Valuation Methodologies

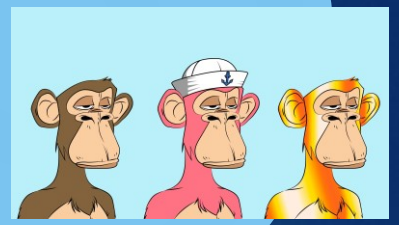
1. Relief from Royalty
2. Excess Earnings
3. Replacement Cost

Tradename Fair Value	$	197,699
Customer Relationships Fair Value	$	144,283
Technology Fair Value	$	168,293
Goodwill	$	187,581
Intangible Assets	**$**	**697,855**

Valuation Consideration for Non-Fungible Tokens

- NFT market surpassed $40 billion in 2021 (Bloomberg).
- NFT is a unique, non-interchangeable digital asset backed by blockchain ledger technology.
- Examples of NFTs range widely from digital art, domain names, games, and collectibles, audio and video recordings.



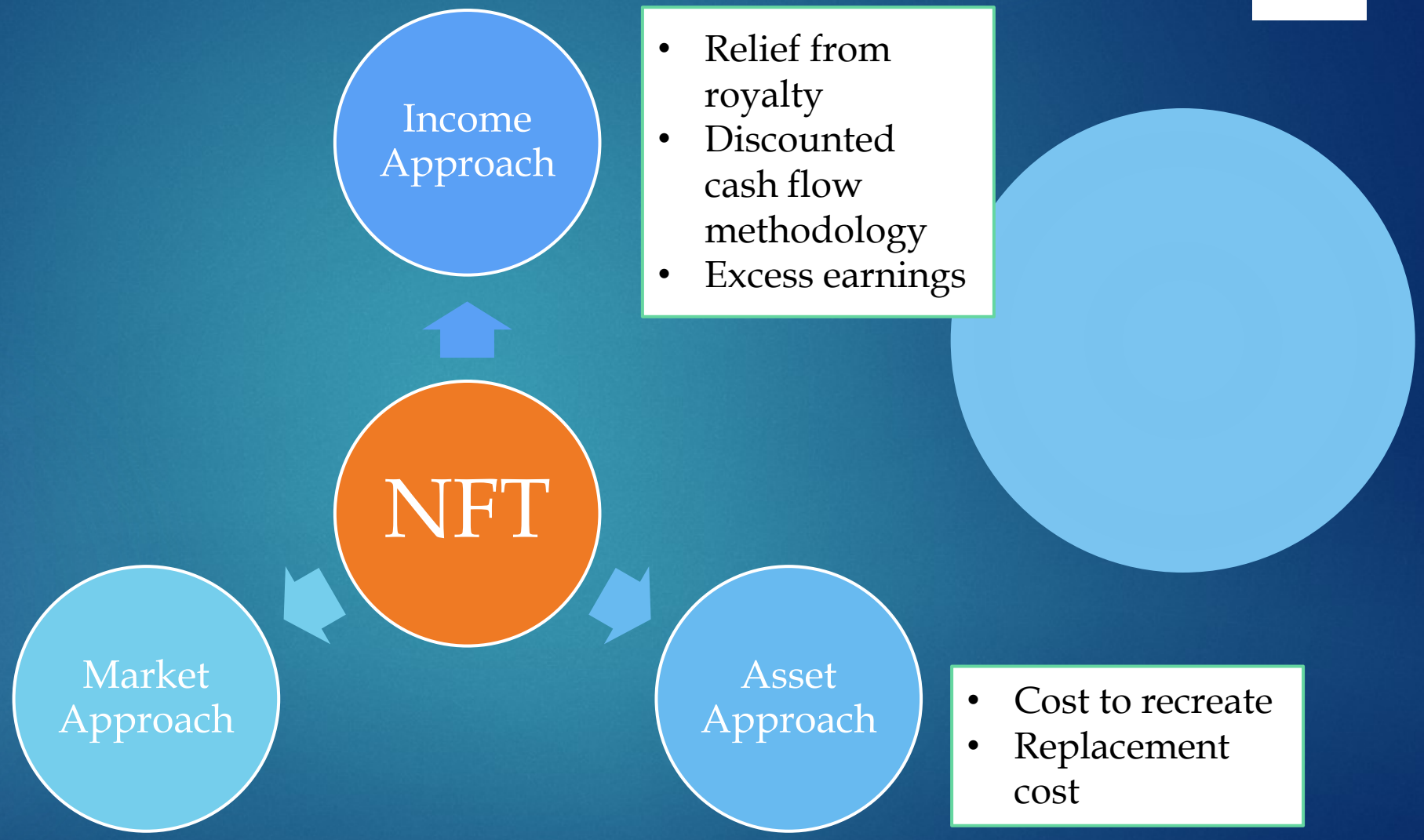


CryptoPunks

Why would anyone buy an NFT?

- Artwork (TokenFrame allows you to display NFT art) & Collectibles
- Support | Speculation | Community (DAO) – decentralized autonomous organization| Status (Sappy Seals)
- Metaverse – interconnected world of digital technologies, including virtual reality, cryptocurrencies, blockchains, NFTs, augmented reality, etc. (Decentraland, Cryptovoxels, Somnium Space)
- Ownership benefits & utility
  - Passive income
  - Intellectual property rights (monetization opportunities: branding, merchandising, animated series, gaming, etc.)
  - Exclusive access or membership (tickets – VeeFriends, VeeCon)
  - Voting rights (Enigma Economy – crypto-mining project)
  - Digital land (build, sell, lease, flip, etc.)
  - Payment method (by purchasing NFT)

Valuation Consideration for NFTs



- Relief from royalty
- Discounted cash flow methodology
- Excess earnings

- Market multiples
- NFT funds: Takung Art (NYSE: TKAT), Funko (NASDAQ: FNKO), and Liquid Media (NASDAQ: YVR)

- Cost to recreate
- Replacement cost

Analytical Issued in Bankruptcy Valuations

- Definition of Value – there is no Bankruptcy Code definition (or Standard) for the term "value." Section 506 provides that "value shall be determined in light of purpose of the valuation and of the proposed disposition or use of such property and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest."
- The analyst's use of hindsight in the bankruptcy valuation is discouraged. The courts seem to adopt the so-called "known or knowable principle" thereby relying on the data as of the valuation date.
- The analyst's reliance on the company management-prepared financial projections should be justified.
- Avoid the use of industry "rules of thumb."
- Use generally accepted valuation approaches and methodologies in the bankruptcy valuation.

What "assets" or conditions are included when valuing the "enterprise" vs. individual assets

- Most enterprise valuations start with a model for future cash flow or EBITDA which (oversimplying) adjusts *past* results to accommodate for changes in the enterprise or the broader economy. "Normalization" is common in the assessment of distressed companies: assuming that idiosyncratic operational or liquidity problems are resolved or temporary broader economy adverse impacts recede.
- Enterprise valuations models then estimate do one of two things:
  - Discount a series of future cash flows or EBITDA results to present value utilizing a broad-economy derived weighted average cost of capital or discount rate
  - Multiply a single normalized annual cash flow or EBITDA by multiple derived form observations of comparable public company enterprise values (equity market capitalization plus debt less cash) or comparable M&A transactions.

How do you decide whether enterprise valuation v. individual valuation is more appropriate?

- Assets that parse as going concern businesses or business segments are appropriately valued on an enterprise basis.
- An asset that consists solely or primarily of real estate is often better individually valued than treated on an enterprise basis.
- Assets which are to be sold separately but which are so integrated into a broader set of assets so as cash flow or EBITDA cannot be meaningfully attributed to them on discreet basis, or which are outright cost centers, would similarly not be valued on an enterprise basis in most cases.

Other Market Approaches

- Courts have rejected expert testimony using traditional valuation approaches when there is contemporaneous market evidence of value.
- Several cases (including decisions from the Third and Fifth Circuit, and SDNY) have looked to the subject company's equity market capitalization as determinative of value in the context of fraudulent transfer actions when there was no reason to distrust the market (e.g., fraud, thinly traded market).
  - For companies with publicly traded debt, stakeholders will often cite to debt trading below par as evidence of value.
- It is important to note that for purposes of determining solvency, courts (including Third Circuit) have rejected the use of trading values of debt. "Unlike assets, debts are measured at their face value and not market value." *In re Lids Corp.*, 281 B.R. 535, 545 (Bankr. D. Del. 2002) *(Travellers Int'l AG v. Trans World Airlines, Inc.*, 134 F.3d at 193).
  - Nevertheless, stakeholders regularly cite to the below-par trading price of debt instruments as evidence of insolvency.
- A court, however, is not bound to accept the value ascribed by the public markets when there is evidence of a reason to distrust the market. Evidence to rebut market-based valuations includes, but is not limited to, financial manipulation, market inefficiencies, or a value derived from a market that is too thinly traded.

Other Market Approaches (continued)

- Bankruptcy courts will often reject expert testimony to determine the value of an asset in a 363 sale context in favor of using the "highest and best offer" to determine value where the offer was the result of "a robust, open and fair process in which substantial marketing and due diligence materials were widely distributed." *In re Boston Generating*, LLC, 440 B.R. 302, 325–28 (Bankr. S.D.N.Y. 2012). *See also Malik v. Falcon Holding*, LLC, 675 F.3d 646, 648 (7th Cir. 2012) (in context of damages calculation involving a business valuation, court noted that an actual market sale transaction is the "gold standard of valuation").

Valuation: Causes of Action

- Bankruptcy estates regularly sell their ongoing lawsuits against affiliates, investors, officers and directors, or third parties, or their rights to sue them. Causes of action must be valued to make sure the sale is at a fair price.
- These causes of action are also regularly included in recoveries of various classes of creditors, and must be valued both for Plan negotiation and Plan confirmation purposes.
- These causes of action include ordinary commercial disputes; disputes of breaches of fiduciary duty or other violations that can only be committed by officers, directors, controlling investors or the like; or causes of action that arise as a result of insolvency, including constructive and intentional fraudulent transfer and the avoidance of preferential transfers.
- Evaluators must consider (a) the potential damages, (b) the ability of defendants or their insurers to pay damages, (c) the odds of prevailing at trial and appeal, (d) the costs of prosecuting the litigation and the various means of financing (from available cash, litigation financing, or contingency arrangements), (e) the time all of the foregoing would take, and (f) how all the parties will treat the foregoing and likely settle the action … and from these considerations reach an estimate the expected net present value of the cause of action.

Strategies for Selecting Valuation Experts

- The most common valuation experts in insolvencies are senior professionals in debtors' or creditors' financial advisory firms. Retaining them as experts delivers very significant cost synergies since they will have the benefit of the work they and their colleagues have already done in the case.
- When no such financial adviser is both available and appropriate, the retention of a separate valuation expert is in order.
- Parties typically look for extensive experience of successful testimony, if valuation is to be contested, or at a minimum a history of qualification as an expert.
  - Has the expert previously been qualified as an expert? Have they published anything inconsistent with their current opinion? Has their work been criticized publicly? How would they perform in deposition or on the witness stand?
- Industry expertise is critical; many veterans of valuation disputes prefer experts with significant hands-on experience in the subject industry, complimenting experience in financial services ancillary to the industry (banking, accounting, brokerage).
- IMPORTANT CAUTION: valuation experts who are expected to testify cannot have their engagements structured to include any significant contingency upon the success of their testimony.

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Strategies for Selecting Valuation Experts -Checklist

- Conflicts?
- Credentials to provide a basis for qualification as an expert without being challenged?
- Industry Experience
- Bankruptcy Experience vs. other valuation experience
- Client base: debtors? Committees? A mix?
- Availability
- Prior qualification, challenges, or disqualifications?
- Prior deposition experience?
- Prior testifying experience?
- Track record? Has the court adopted or rejected your opinions?
- Any published decisions?
- Experience before judge or particular court?
- Previous work for or against other side(s)
- Previous work with opposition expert?
- Relevant publications?
- Fees and fee structure?
- Can the expert testify persuasively and stand up to rigorous cross examination?