Published on *The National Law Review* https://natlawreview.com

5 Questions with Stuart Gilson: Creating Firm Value

Article By:

Cornerstone Research

We interview Professor Stuart C. Gilson of the Harvard Business School to gain his insights on how firms create value. Professor Gilson is an expert on valuation, credit and financial statement analysis, and corporate transactions. He has developed several Harvard Business School case studies for teaching MBAs and executives.

How do firms create value?

As a general principle, firms create value by pursuing business strategies and providing products and services that create a sustainable competitive advantage in the marketplace. Firms that consistently produce a higher cash return for their investors than they could earn in alternative investment opportunities are rewarded with higher market values.

What are some of the factors that can cause a firm’s value to change?

A firm’s market value can fluctuate over time in response to a multitude of factors that can be difficult or impossible to predict. These factors impact value by affecting either the firm’s future cash flows or its cost of capital. Competition, technological change, and adverse economic shocks constantly challenge a firm’s ability to achieve sustained superior financial performance.

Events that could negatively impact firm value include departures of key executives, manufacturing line shutdowns, product lawsuits, supply chain disruptions, increases in the prices of key commodity inputs, increases in interest rates, price reductions by a competitor, adverse foreign exchange rate changes, and the loss of significant customers. Technological change can be a firm’s best friend or its worst enemy. The whole economy can suffer a cyclical downturn. The list is virtually endless.

How can firms respond to a decline in value?

Firms that experience significant declines in their performance and competitive position will generally see their market values decline significantly. If the resulting “value gap” is sufficiently large, putting the firm’s independence (or even its survival) at risk, it may have no choice but to dramatically restructure its business operations, assets, or capital structure.

Restructuring generally involves renegotiation or “recontracting” with key stakeholders. Determining the value of the company's business, or the value of financial claims outstanding against the company's assets and cash flows, is critical to overcoming the challenges that confront the firm, and to understanding how shareholders, creditors, employees, and other stakeholders are affected by the restructuring.

Restructuring a firm's assets and operations often involves:

- Cutting expenses, including layoffs and reductions in employee compensation.
- Selling or spinning off certain assets or business divisions, often in conjunction with significant changes to the firm's equity ownership structure.

- Restructuring the firm's debt and other liabilities.

For example, as an alternative to selling off an operating subsidiary (which can create a sizeable tax liability), the assets in question can be divested through a tax-free spin-off or split-off (giving the parent firm's shareholders the option of keeping or retaining their ownership in the subsidiary), or ownership of the subsidiary can be partially monetized through an equity carve-out.

Finally, firms that are financially distressed, and at risk of defaulting on their debt or filing for bankruptcy, may have to restructure their debt and other liabilities. The debt may be privately held or publicly traded, and creditors will often include a multitude of different parties (often with opposing interests), including banks, insurance companies, hedge funds, private equity firms, vendors and suppliers, employees (active and retired), governments, or other companies. Strategies for restructuring the debt can include filing for Chapter 11 bankruptcy protection, negotiating a consensual restructuring with creditors out of court, or pursuing a hybrid of the first two by filing a "prepackaged" or "prearranged" Chapter 11 bankruptcy plan.

What are some hotly contested issues in firm valuation?

An especially contentious issue that often comes up in debt restructurings concerns the estimated market value of the firm's assets and business operations, known as its "enterprise value." Enterprise value reflects the present value of the firm's future cash flows available to creditors and shareholders after the firm emerges from Chapter 11 or completes an out of court restructuring. This determines the financial recoveries that current creditors and shareholders are able to realize from the restructuring.

Most often, however, the firm's enterprise value is unknown—it has to be estimated. This can produce significant disagreement among creditors who have different levels of seniority. Junior creditors have an economic incentive to argue that enterprise value is high (i.e., high enough to support a full recovery on their claims). But senior creditors have exactly the opposite incentive, to argue that enterprise value is low (and just high enough to make them whole, which may also entitle them to most of the equity—and upside—in the reorganized firm).

Resolving such conflicts over value, and reconciling different values obtained using different methodologies based on different assumptions about the firm's business, is sometimes one of the greatest challenges to achieving a successful restructuring. For large companies such competing enterprise valuations can be hundreds of millions of dollars apart.

Disagreements over value also often come up in litigation brought against firms that default on their debt or file for bankruptcy following a leveraged buyout, acquisition, or asset sale, where the firm's financial solvency around the time of the transaction is at issue. Estimating the firm's enterprise value, and assessing its financial health and ability to meet its debt obligations over time, is a key part of determining the firm's exposure to liability.

What are some of the key challenges experts face when conducting a valuation in an M&A or bankruptcy setting?

In a bankruptcy setting, because there is no definition of value in the Bankruptcy Code, experts may disagree over what definition of value (e.g., fair value or market value) is appropriate. An expert's valuation of a firm in bankruptcy might be questioned for relying on financial projections provided by the firm's management. For firms emerging from bankruptcy, experts might disagree over what valuation methodologies (e.g., discounted cash flow or comparable traded company multiples) are appropriate and whether to use market prices to value the company

For valuations in connection with mergers and acquisitions, a major challenge for experts is estimating the value of merger synergies—the additional value created by combining the assets and operations of bidder and target companies—as well as the merging companies' stand-alone values. These values are critical determinants of the financial benefits that bidder and target company owners realize, and of whether the merger will ultimately succeed. In the case of acquisitions that are financed with debt, mistakes in valuation can even imperil the solvency of the merged firm.

National Law Review, Volume X, Number 221