

# To Be or Not to Be Confirmed: A Debtor's Post-Reorganization Viability

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The issue of viability can often be at the center of a plan-confirmation hearing. Will the reorganized entity be a viable going-concern, or will it be liquidated or need further financial reorganization in the foreseeable future? The answer is often contested and disputed throughout the confirmation process. Demonstrating whether an entity will be a viable going-concern post-confirmation can be a determining factor in whether the plan of reorganization is confirmed.



Dr. Israel Shaked

The authors have seen reorganization plans that both try to save and preserve already-established businesses, as well as create new businesses in new industries. We are not here to opine or comment on what a reorganization plan should be used for, that is for attorneys to argue. This article addresses the various issues and factors that might be analyzed in order to determine whether a reorganized entity will be a viable going-concern.

A going-concern is typically defined as an entity that is expected to operate indefinitely or for the foreseeable future. A disclosure statement is typically filed in conjunction with a plan of reorganization and usually contains financial projections for the reorganized entity. Those projections are often used as the basis to demonstrate that the reorganized entity will be viable. Therefore, it is important to analyze and test the reasonableness of those projections. Are the projections' underlying assumptions substantiated? Do the projections present an accurate picture of the entity after its plan of reorganization is confirmed? Do they reasonably reflect the reorganized entity's operat-

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ing environment and its ability to operate in that environment? Do they project out only a couple of years, or are they mid- to long-term projections?

Several years ago, there was an article<sup>1</sup> that tested whether U.S. companies emerging from bankruptcy over- or underperformed their projections. The companies analyzed had filed for chapter 11, produced disclosure statements that included financial projections, emerged from bankruptcy as public companies with standard Securities and Exchange Commission documents and had two to

The article also found that the direction of the deviation between actual results and projections were typically stable. Thus, underperforming in the first year typically means underperforming in the next two years. In addition, the article found that deviations between actual results and projected performance typically increased. For instance, the median amount by which each projection was either over- or underestimated increased from year one to year three for eight of the nine financial-statement measures.<sup>2</sup>

A complete set of financial projections for the reorganized entity usually includes an income statement, balance sheet and statement of cash flows. However, there have been instances

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five years of actual performance data. The article tested the emerging companies' actual results vs. their projections for nine financial-statement measures. The following is a sample of some of the article's findings.

In year one, 72.7 percent of emerging companies were below their projected net sales, 62.7 percent of emerging companies were below their projected net income, and 63.2 percent of emerging companies were below their projected cash flow from operations. In year two, 66.7 percent of emerging companies were below their projected net sales, 71.0 percent of emerging companies were below their projected net income and 57.1 percent of emerging companies were below their projected cash flow from operations. In year three, 68.2 percent of emerging companies were below their projected net sales, 72.7 percent of emerging companies were below their projected net income and 58.8 percent of emerging companies were below their projected cash flow from operations.

where the income statement is the only financial statement that is projected and the entity's projected net income is the only factor relied on when trying to determine viability. While net income is important, it should not be the sole variable that is analyzed and relied upon. A reorganized entity may project positive net income but it may not be able to turn those earnings into cash and satisfy its future debts as they become due. Therefore, it is important to also analyze other factors, such as the entity's projected working-capital needs and cash flows. The fact that a reorganized entity projects positive net income does not necessarily mean that it will not be liquidated or need further financial reorganization in the foreseeable future.

Depending on whether the reorganized entity is saving or preserving an already-established business or it is attempting to create new businesses in new industries, there are various factors that might be analyzed when determining its viability. However, in both instances, the reorganized entity should not be ana-

<sup>1</sup> Allen Michel, Israel Shaked and Christopher McHugh, "After Bankruptcy: Can Ugly Ducklings Turn into Swans?" *Financial Analysts Journal*, May/June 1998.

<sup>2</sup> See Michel, Shaked and McHugh, n.1

lyzed in isolation. It is important to also analyze the entity's industry and its ability to operate and compete in that industry.

For reorganized entities that are saving or preserving already-established businesses, the changes that occurred in the entity's operations and industry since its bankruptcy filing should be analyzed and understood. For instance, has the entity lost any market share since it filed for bankruptcy? If yes, will it be able to regain the lost market share, or will it operate as a smaller player in the industry? Have there been any structural changes in the industry? If yes, is the reorganized entity equipped to compete and operate in a changing industry? Moreover, are the entity's projected operating margins better or worse than its historical margins? If the projected margins are better, what is causing the improvements? Are they permanent or just temporary? If the projected margins are worse, can the reorganized entity last in the long run while earning less per dollar of revenue than it did historically? Did the entity's cost of capital change? Is it more expensive for the reorganized entity to raise capital? If yes, will the entity be able to raise the capital it needs in order to operate?

These are examples of just some of the types of analyses that might be undertaken. Depending on the entity, its maturity and its industry, certain factors may be more important than others in determining its ability to emerge from bankruptcy as a viable going-concern.

For reorganized entities that are attempting to create new businesses in new industries, the entities' ability to enter and penetrate the market should be analyzed and understood. Similar to other start-ups and new entrants to the market, these reorganized entities will face various barriers to entry. Barriers to entry differ from industry to industry as a result of the markets served and the age of the industry.

For instance, it is typically more difficult to enter mature industries as a new entrant and earn profits. How will the reorganized entity overcome these barriers? How will the existing players in the market react and retaliate? Moreover, does the reorganized entity have any customers? If not, how will it be able to obtain customers? What differentiates it from the existing market players? What is the pricing in the industry? How does the reorganized entity's pricing compare with the

industry? How does the reorganized entity's projected margins compare with the industry's margins? Do the existing market players have economies of scale? How long will it take the reorganized entity to have economies of scale?

These are examples of just some of the types of analyses that might be undertaken. Depending on the entity and the industry it is attempting to penetrate, certain factors may be more important than others in determining its ability to emerge from bankruptcy as a viable going-concern.

The viability of a reorganized entity is often at the center of a plan confirmation hearing. To demonstrate viability, the reorganized entity's projections are often used. There have been deviations between emerging entities' actual results and projections. Therefore, it is important to not blindly rely on projected financials; instead, the projections should be analyzed and tested for reasonableness. It is important to not analyze the reorganized entity in a vacuum. An in-depth analysis and understanding of the reorganized entity's business and its industry is important in determining the entity's ability to operate into the foreseeable future. ■