Houlihan Lokey

A Valuation Framework for Litigation Finance Assets

Executive Summary

Third-party litigation finance (TPLF) is a growing asset class. Estimating the fair value of TPLF assets can be difficult due to the lack of publicly traded comparables and the bespoke nature of individual litigation claims. The valuation of these assets can be extremely complex. This white paper provides a framework that could be useful when valuing single-case, equity-like TPLF assets under ASC 820 for financial reporting purposes and should not be viewed as guidance on the valuation of these assets for any other purpose. A simplified example is also provided to illustrate the mechanics of this framework.

Introduction and Background

Litigation matters have challenging economics, as costs are incurred throughout the course of the litigation with typically no incoming cash flows until the matter is settled or finally adjudicated. These economics have contributed to the growth of the third-party litigation financing market, where an investor provides capital on a nonrecourse basis to a law firm or litigant in exchange for a negotiated share of any recoveries from the matter. Law firms use TPLF to increase their caseload, and corporate plaintiffs use TPLF to fund the litigation or to partially monetize an otherwise illiquid asset. TPLF is typically geared toward commercial claims (e.g., breach of contract, patent infringement, fraud, class actions) and consumer claims (e.g., personal injury). There are typically two types of TPLF funding arrangements: single-case and litigation portfolio, where the financing is used for multiple cases.

The valuation of TPLF assets (the "Assets") can be challenging. Traditional valuation approaches, such as the market approach and the transaction approach, are typically not applicable due to the lack of relevant metrics to capitalize and the bespoke nature of the underlying claims. Unlike a business that can be valued as a multiple of revenues, EBITDA, or earnings, the Assets typically do not have representative metrics that can be easily capitalized. Individual Assets are often highly customized with structured payoffs to the financier, resulting in noncomparable economics across litigation matters. In addition, the value of an Asset over time can be lumpy based on the outcomes of conditional events (milestones), such as settlements, court rulings, and appeals. As a result, the income approach (such as the discounted cash flow approach) is commonly used to value the Assets.

Possible Valuation Framework for TPLF Assets

We provide the following framework as a possible approach to valuing equity-like investments in single-case Assets. This framework has four steps:

- **Step 1: Underwriting Assumptions**

  Start with underwriting assumptions[1] regarding the ultimate amount that would be won if successful (the "Unadjusted Expected Value" or "UEV"), time to payment, the nature and timing of milestones, and other relevant factors. The UEV may represent the TPLF provider's (the "Investor") best guess as to, or probability-weighted estimate of, the final award.

- **Step 2: Discount Rate and UEV Discount Estimation**

  Estimate a discount rate (or range of discount rates) and calculate an implied Unadjusted Expected Value discount (UEV Discount).

[1] *If there is a more recent fair value transaction, assumptions from that transaction should be used. However, as Assets typically do not trade, this white paper assumes no additional transactions after initial underwriting.*

Determination of Discount Rate

It is easier to conceptualize the discount rate by working backward from the case timeline (i.e., starting with the final award in the case), assuming that the litigation has a successful outcome for the Investor. We ask ourselves what discount rate should be applied to this award. This should reflect the riskiness of the counterparty's ability to pay the judgment, the structure of the payout, the difficulty of collection, and other factors. The discount rate may also be impacted by other factors, such as the structure of the payout and the difficulty of collection. It may also be appropriate to adjust the discount rate for lack of liquidity of the Asset.

Estimation of a UEV Discount at the Time of Investment

We define a UEV Discount as the discount to the expected final award due to risks of losing the litigation and uncertainty of the amount of the final award. Since we have an estimated UEV, time to award, discount rate, and purchase price for the Asset, we can estimate a UEV Discount based on the premise that the present value of the Unadjusted Expected Value after the UEV Discount should equal the purchase price, or:

$$(\text{Unadjusted Expected Value} * (1 - \text{UEV Discount})) / (1 + r)^t = \text{Purchase Price}$$

where:

r = discount rate,

t = time to award.

Rearranging, we get:

$$\text{UEV Discount} = 1 - (\text{Purchase Price} * (1 + r)^t) / \text{Unadjusted Expected Value}$$

- **Step 3: Milestone Probability and Litigation Risk Discount Estimation**

Based on the implied UEV Discount, estimate the probabilities of winning or losing at each remaining milestone and Litigation Risk Discount.

In Step 2, we started with the equation:

$$(\text{Unadjusted Expected Value} * (1 - \text{UEV Discount})) / (1 + r)^t = \text{Purchase Price}$$

We now consider what "1 - UEV Discount" represents from a conceptual standpoint. This formula reflects a reduction in the UEV. Two possible reasons for the reduction are the probability of losing the litigation (P_L) and the uncertainty of the UEV estimate. An overstated UEV estimate can be reduced by a Litigation Risk Discount (LRD). We can incorporate these two factors as follows:

$$(1 - \text{UEV Discount}) = (1 - P_L) * (1 - \text{LRD})$$

Substituting into the first equation, we get:

$$(\text{Unadjusted Expected Value} * (1 - P_L) * (1 - \text{LRD})) / (1 + r)^t = \text{Purchase Price}$$

We now need to estimate the probability of losing the litigation and the LRD. We believe it is better to start by estimating the litigation win/loss probabilities. Typically, prior to making an investment, an Investor will assess the merits of a potential case. Often, the Investor will have estimates (perhaps derived from their history of investments in litigation assets or conversations with the underlying law firm or consultants) of the likelihood of success of each milestone event. The Investor may also have a view on the riskiness of the UEV, which may impact selected UEV Discount and LRD. After the probability of winning/losing the litigation has been estimated, the LRD can then be calculated.

The LRD and probability of winning the litigation are not necessarily static numbers and should be revised based on case developments and other relevant factors.

- **Step 4: Fair Value Estimation**

Fair value at subsequent valuation dates is estimated via a present value calculation:

$$\text{Fair Value} = (\text{Unadjusted Expected Value} * (1 - P_L) * (1 - \text{LRD})) / (1 + r)^t$$

Here is a simplified illustration of this framework to show the interplay of the variables in the framework.

Example

Step 1: Underwriting Assumptions

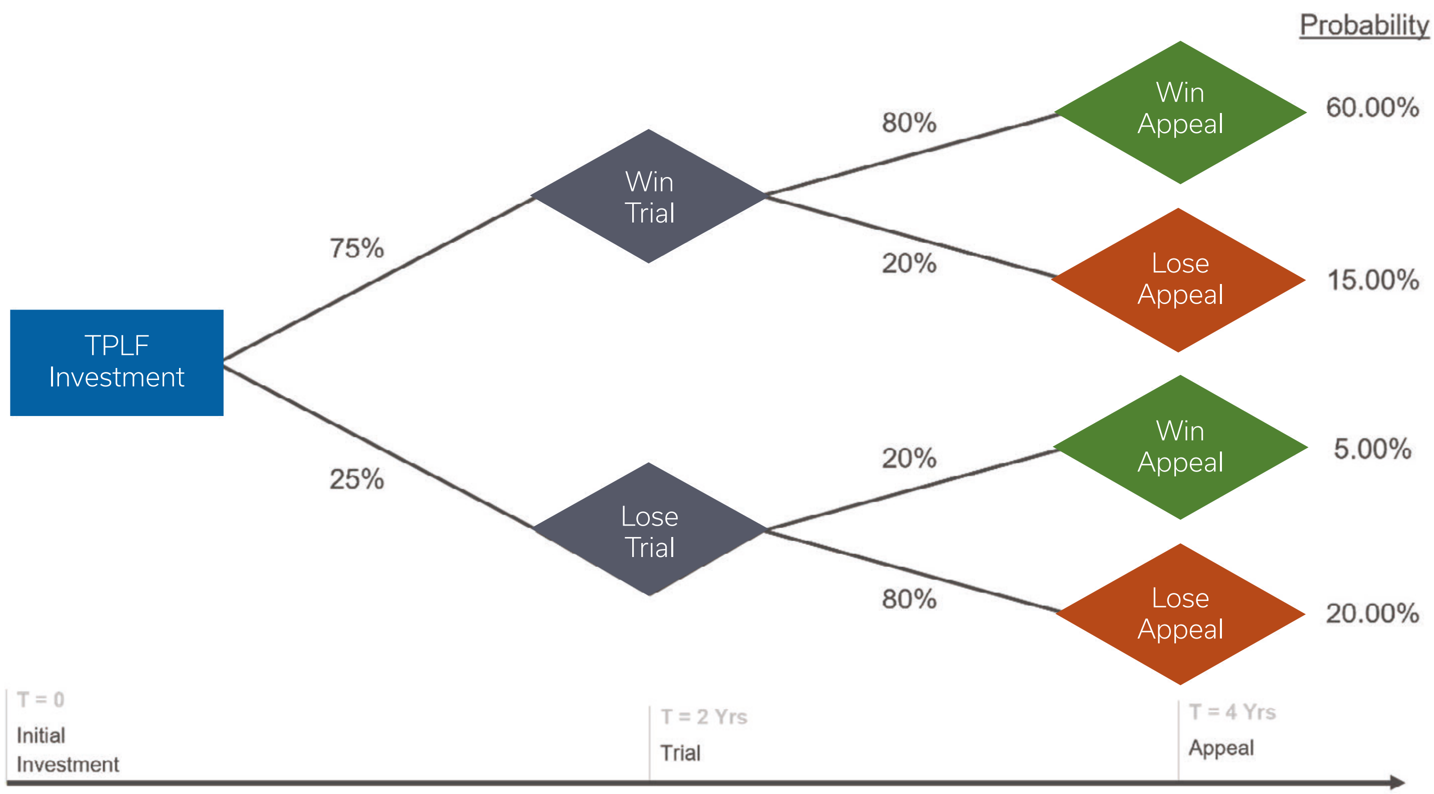
Time until final judgment: Four years.
Milestones: (i) The initial trial with a ruling in two years and (ii) an appeal with a ruling in an additional two years. After the ruling in the appeal, any award is deemed final.
Unadjusted Expected Value: $100 million.
Investor purchase price: $40 million, which is paid up front and expected to fully fund the trial and appeal.

Step 2: Discount Rate and UEV Discount Estimation

The appropriate discount rate is estimated to be 7%.
The implied expected future cash flow is approximately $52.4 million[(2)], which implies a UEV Discount of 47.6%.

Step 3: Milestone Probability and Litigation Risk Discount Estimation

In this case, it is believed that the UEV Discount is composed of the risk of loss at the milestone events as well as uncertainty on the final award. After consideration of the UEV Discount, comparable case experience, and other relevant factors, the Investor estimates the milestone probabilities, which are shown in the flowchart below:



These probabilities indicate that the probability of ultimately losing the case is 35%. Since the UEV Discount was determined to be 47.6%, the implied LRD is 20%.[(3)]

Step 4: Fair Value Estimation

Fair Value Estimation One Year After Investment

Assuming no changes in a market participant's view of the litigation or the discount rate, the fair value of the Investor's share of the litigation would be calculated to be $42.8 million.[(4)]

(2) $52.4 million / 1.07^4 = $40 million.
(3) (1 - 35%) (1 - LRD) = (1 - 47.6%).
(4) $52.4 million / 1.07^3.

Fair Value Estimation Two Years and Three Years After Investment: Win at Trial Scenario

Assume that two years after the investment, the plaintiff has been successful at trial and awarded \$100 million, but the matter has been appealed. Also, assume that the probability of winning the appeal is estimated to be 80%. Given the amount awarded by the court, the appeal, and after considering other relevant factors, the LRD is reduced from 20% to 10%. Thus, the total UEV Discount is 28.0%.

The corresponding valuation inputs are:

Unadjusted Expected Value: \$100 Million	LRD: 10%
Litigation Loss Probability: 20%	Discount Rate: 7%
Time to End of Case and Receipt of Judgment: Two Years	

The resulting fair value indications are:

Time Since Investment	Fair Value
Two Years	\$62.9 Million[5]
Three Years	\$67.3 Million[6]

Fair Value Estimation Two and Three Years After Investment: Lose at Trial Scenario

Assume that two years after the investment, the plaintiff has lost at trial and filed an appeal. The probability of losing on appeal is still believed to be 80%. Additionally, the LRD has been increased to 30% based on the facts and circumstances of the case.

The corresponding valuation inputs are:

Unadjusted Expected Value: \$100 Million	LRD: 30%
Litigation Loss Probability: 80%	Discount Rate: 7%
Time to End of Case and Receipt of Judgment: Two Years	

The resulting fair value indications are:

Time Since Investment	Fair Value
Two Years	\$12.2 Million[7]
Three Years	\$13.1 Million[8]

Fair Value Estimation at Year Four

Once the case has been finally adjudicated, the fair value would be \$0 if the plaintiff loses and the fair value of the final judgment if the plaintiff wins.

Settlements, Drawdowns, and Other Considerations

This example is very simplistic as it assumes that the Asset is fully funded at the start; it is more common for funds to be drawn upon as needed. The example also does not consider settlements, which are typically a key milestone. The framework can be expanded to handle these and other considerations.

Valuation of Debt-Like Assets

So far, our valuation framework has been focused on equity-like investments where the Asset represents a pro-rata share of ultimate litigation recoveries; however, TPLF can also be debt-like. For example, the litigation asset may entitle the holder to the first distributions up to a multiple of their investment or up to a stated rate of return (the "Debt-Like Assets"). Debt-Like Assets may also be a part of an asset that has a waterfall. For example, distributions from litigation cash flows may be allocated as follows: (i) first, to the Asset in an amount equal to the capital provided plus a return (the "Initial Distribution"), (ii) second, to the law firm or corporation up to a certain amount, (iii) third, split 75%/25% between the parties until a certain return is made by the Investor, and (iv) fourth, any remaining cash flows would be split 50%/50%. The framework can be adjusted to value Debt-Like Assets; however, this may still require the estimation of variables from an equity perspective.

[5] (\$100 million x (1 - 20%) x (1 - 10%)) / 1.07^2.
[6] (\$100 million x (1 - 20%) x (1 - 10%)) / 1.07.
[7] (\$100 million x (1 - 80%) x (1 - 30%)) / 1.07^2.
[8] (\$100 million x (1 - 80%) x (1 - 30%)) / 1.07.

CONTACT

Please reach out to the team member below for more information.

Terence Tchen
Senior Advisor
+1 310.788.5235
TTchen@HL.com

LEADING INDEPENDENT, GLOBAL ADVISORY FIRM

Corporate Finance

- No. 1 Global M&A Advisor Under $1 Billion
- Leading Capital Markets Advisor Raising Approx. $25 Billion Over the Past Two Years

2022 M&A Advisory Rankings Global Transactions Under $1 Billion

	Advisor	Deals
1	**Houlihan Lokey**	**381**
2	Rothschild	369
3	JP Morgan	217

Source: Refinitiv. Excludes accounting firms and brokers.

Financial Restructuring

- No. 1 Global Restructuring Advisor
- $3.0 Trillion of Aggregate Transaction Value Completed

2022 Global Distressed Debt and Bankruptcy Restructuring Rankings

	Advisor	Deals
1	**Houlihan Lokey**	**58**
2	PJT Partners	30
3	Lazard	29

Source: Refinitiv.

Financial and Valuation Advisory

- No. 1 Global M&A Fairness Opinion Advisor Over the Past 25 Years
- 1,000+ Annual Valuation Engagements

1998 to 2022 Global M&A Fairness Advisory Rankings

	Advisor	Deals
1	**Houlihan Lokey**	**1,232**
2	JP Morgan	1,030
3	Duff & Phelps, A Kroll Business	938

Source: Refinitiv. Announced or completed transactions.

Financial Sponsors Coverage

- No. 1 Global Private Equity M&A Advisor
- 1,000+ Sponsors Covered Globally

2022 Most Active Global Investment Banks to Private Equity Firms

	Advisor	Deals
1	**Houlihan Lokey**	**242**
2	Lincoln International	192
3	Deloitte	190

Source: PitchBook.

ABOUT PORTFOLIO VALUATION AND FUND ADVISORY SERVICES

Houlihan Lokey's Portfolio Valuation and Fund Advisory Services practice is a leading advisor to many of the world's largest asset managers who rely on our strong reputation with regulators, auditors, and investors; private company, structured product, and derivative valuation experience; and independent voice. We value illiquid assets on behalf of hundreds of hedge funds, private equity firms, financial institutions, corporations, and investors. We rapidly mobilize the right team for the job, drawing on our expertise in a wide variety of asset classes and industries, along with our real-world transaction experience and market knowledge, from our dedicated global Financial and Valuation Advisory business.

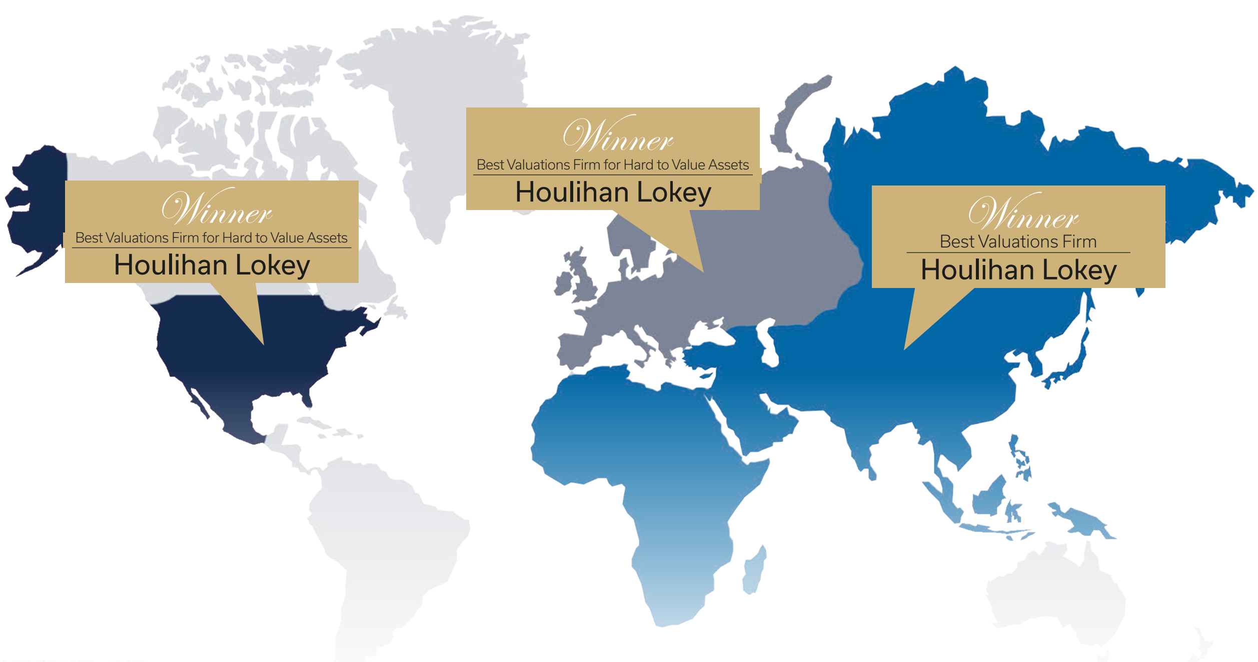
OUR SERVICE AREAS

Portfolio Valuation and Fund Advisory Services

- Fair Valuation for Financial Reporting
- Securitization and Regulatory Compliance
- Portfolio Acquisition and Divestiture Services
- GP and Fund Manager Valuation
- Valuation Governance and Best Practices
- Structured Products Valuation Advisory
- Derivatives Valuation and Risk Management
- Fund Recapitalization and Transaction Opinions

GLOBAL RECOGNITION

The HFM Services Awards named Houlihan Lokey "Best Valuations Firm for Hard to Value Assets" in the U.S. in 2018–2023 and in Europe in 2020–2023, and it was named "Best Valuations Firm" in Asia in 2020–2023. Houlihan Lokey has now won these awards in all three geographic regions for four consecutive years!



The HFM Services Awards recognize hedge fund service providers that have demonstrated exceptional client service, innovative product development, and strong and sustainable business growth over the prior 12 months.

Houlihan Lokey

LEADING GLOBAL, INDEPENDENT INVESTMENT BANK

Americas		Europe and Middle East		Asia-Pacific	
Atlanta	Miami	Amsterdam	Milan	Beijing	Nagoya
Baltimore	Minneapolis	Antwerp	Munich	Fukuoka	Shanghai
Boston	New York	Dubai	Paris	Gurugram	Singapore
Chicago	San Francisco	Frankfurt	Stockholm	Hong Kong SAR	Sydney
Dallas	São Paulo	London	Tel Aviv	Mumbai	Tokyo
Houston	Washington, D.C.	Madrid	Zurich		
Los Angeles		Manchester			

HLI
LISTED
NYSE

Important Disclosure

Houlihan Lokey is a trade name for Houlihan Lokey, Inc., and its subsidiaries and affiliates, which include the following licensed (or, in the case of Singapore, exempt) entities: in (i) the United States: Houlihan Lokey Capital, Inc., and Houlihan Lokey Advisors, LLC, each an SEC-registered broker-dealer and member of FINRA (www.finra.org) and SIPC (www.sipc.org) (investment banking services); (ii) Europe: Houlihan Lokey Advisory Limited, Houlihan Lokey EMEA, LLP, Houlihan Lokey (Corporate Finance) Limited, and Houlihan Lokey UK Limited, authorized and regulated by the U.K. Financial Conduct Authority; Houlihan Lokey (Europe) GmbH, authorized and regulated by the German Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht); (iii) the United Arab Emirates, Dubai International Financial Centre (Dubai): Houlihan Lokey (MEA Financial Advisory) Limited, regulated by the Dubai Financial Services Authority for the provision of advising on financial products, arranging deals in investments, and arranging credit and advising on credit to professional clients only; (iv) Singapore: Houlihan Lokey (Singapore) Private Limited and Houlihan Lokey Advisers Singapore Private Limited, each an "exempt corporate finance adviser" able to provide exempt corporate finance advisory services to accredited investors only; (v) Hong Kong SAR: Houlihan Lokey (China) Limited, licensed in Hong Kong by the Securities and Futures Commission to conduct Type 1, 4, and 6 regulated activities to professional investors only; (vi) India: Houlihan Lokey Advisory (India) Private Limited, registered as an investment adviser with the Securities and Exchange Board of India (registration number INA000001217); and (vii) Australia: Houlihan Lokey (Australia) Pty Limited (ABN 74 601 825 227), a company incorporated in Australia and licensed by the Australian Securities and Investments Commission (AFSL number 474953) in respect of financial services provided to wholesale clients only. In the United Kingdom, European Economic Area (EEA), Dubai, Singapore, Hong Kong, India, and Australia, this communication is directed to intended recipients, including actual or potential professional clients (UK, EEA, and Dubai), accredited investors (Singapore), professional investors (Hong Kong), and wholesale clients (Australia), respectively. No entity affiliated with Houlihan Lokey, Inc., provides banking or securities brokerage services and is not subject to FINMA supervision in Switzerland or similar regulatory authorities in other jurisdictions. Other persons, such as retail clients, are NOT the intended recipients of our communications or services and should not act upon this communication.

Houlihan Lokey gathers its data from sources it considers reliable; however, it does not guarantee the accuracy or completeness of the information provided within this presentation. The material presented reflects information known to the authors at the time this presentation was written, and this information is subject to change. Any forward-looking information and statements contained herein are subject to various risks and uncertainties, many of which are difficult to predict, that could cause actual results and developments to differ materially from those expressed in, or implied or projected by, the forward-looking information and statements. In addition, past performance should not be taken as an indication or guarantee of future performance, and information contained herein may be subject to variation as a result of currency fluctuations. Houlihan Lokey makes no representations or warranties, expressed or implied, regarding the accuracy of this material. The views expressed in this material accurately reflect the personal views of the authors regarding the subject securities and issuers and do not necessarily coincide with those of Houlihan Lokey. Officers, directors, and partners in the Houlihan Lokey group of companies may have positions in the securities of the companies discussed. This presentation does not constitute advice or a recommendation, offer, or solicitation with respect to the securities of any company discussed herein, is not intended to provide information upon which to base an investment decision, and should not be construed as such. Houlihan Lokey or its affiliates may from time to time provide financial or related services to these companies. Like all Houlihan Lokey employees, the authors of this presentation receive compensation that is affected by overall firm profitability.