Financial Adviser Insights

Factors to Consider in Performing a Valuation Analysis for a Fairness Opinion

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Valuation analyses are at the core of any fairness opinion analysis. There are several factors that should be considered in performing valuation analyses for a fairness opinion that do not apply in a normal business/security valuation engagement. An understanding of these factors will better enable the financial adviser to prepare a more useful fairness opinion.

Introduction

A fairness opinion is an opinion from a financial adviser as to whether a transaction is fair, from a financial point of view. The fairness opinion is directed to a particular constituent in a prospective transaction. A fairness opinion may be issued on behalf of a buyer, on behalf of a seller, or from an independent perspective.

Firms that provide business valuation consulting services frequently also provide fairness opinions and other transactional services. Valuation analyses are the core of a fairness opinion.

This discussion summarizes the factors that the financial adviser should consider when performing valuation analyses for the purpose of issuing a fairness opinion.

A fairness opinion provider is usually retained by a fiduciary representing a particular constituency (such as the board of directors of a company in a prospective transaction). In preparing a fairness opinion analysis and presentation, the financial adviser should consider that the audience for the fairness opinion is ultimately both:

1. the fiduciary that directly requested the fairness opinion and
2. any shareholders and other stakeholders that are constituents.[1]

If the proposed transaction is to go forward, the financial adviser will often give a presentation to the fiduciary. At this presentation, the fairness opinion provider should be prepared to answer questions regarding every valuation-related decision that was made during the fairness opinion preparation process.

No Conclusion of Value

At the outset, it is important to consider an important distinction between a valuation analysis and a fairness opinion. A valuation analysis typically presents a conclusion of value (or sometimes a range of values). A fairness opinion, on the other hand, typically presents valuation indications from several valuation approaches and methods, but does not synthesize these valuation indications into a single valuation conclusion.

The fairness opinion merely opines as to whether or not the deal is fair from a financial point of view to the party that requested the fairness opinion.

In performing valuation analyses for a fairness opinion assignment, the financial adviser may be faced with a situation where one or more valuation indications are significantly different from the price of the prospective transaction. The financial adviser should be prepared to explain the differences between the deal price and the "wayward" value indications.

Standard of Value

One of the first decisions to be made in performing a valuation analysis is the determination of the standard of value. A fairness opinion, on the other hand, is usually not required to have a specified standard of value. However, the financial adviser preparing a fairness opinion should consider any standards of value that may be relevant to the particular assignment.

One of the most common standards of value is fair market value. Fair market value may be defined as "the amount at which property would change hands between a willing

seller and a willing buyer when neither is acting under compulsion and when both have reasonable knowledge of the relevant facts.”[2]

Since fair market value considers hypothetical market participants, estimates of fair market value are an appropriate estimate of the minimum “fair” price of a prospective transaction.

Another standard of value that may be considered by the financial adviser is investment value. Investment value may be defined as “the specific value of an investment to a particular investor or class of investors based on individual investment requirements; distinguished from market value, which is impersonal and detached.”[3]

Each prospective bidder for a company will have its own estimate of the investment value of the target. The bidder with the highest estimate of investment value will indicate a price for the target company that may be seen as the maximum price a buyer is willing to pay for the target company.

In some cases, the nature of the transaction and/or the legal jurisdiction of the companies involved in the prospective transaction will suggest a standard of value that should be considered. For example, many companies are formed in the State of Delaware, which is viewed as the national standard-setter for regulation of public corporations. For many transactions involving Delaware companies, the standard of value of fair value should be considered.

According to Section 262 of the General Corporation Law of the State of Delaware, in assessing appraisal rights, “the Court shall appraise the shares, determining their fair value exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation. . . .”[4]

A valuation analyst providing a fairness opinion for a Delaware corporation should therefore determine whether fair value is the relevant standard of value for the subject assignment.

Incidentally, some financial advisers mistakenly think that fair market value is always lower than fair value. This is not true. The facts and circumstances of each company and situation will affect which of these value indications is higher.

The Range of “Fair” Prices

At this stage, the analysis has defined a theoretical range of possible transaction prices. Under this framework, the transaction price should be:

1. greater than or equal to the fair value or fair market value of the seller (as appropriate) and
2. less than or equal to the investment value to the highest bidder.

The transaction price will not always fall within this theoretical framework due to specific factors of each transaction. And, the ultimate transaction price is also affected by:

1. the number of bidders and
2. the negotiating power and bargaining position of the parties.

The Role of a Fairness Opinion

As discussed above, a fairness opinion is an opinion from a financial adviser as to whether a transaction is fair, from a financial point of view, to a particular constituent in a prospective transaction.

A fairness opinion is not:

1. an estimate of the proper price of a deal, or
2. a recommendation on whether to pursue a deal.

Regardless of what a fairness opinion is or isn’t, the selling shareholders may want to know why the price they are receiving is not as high as the values indicated by certain valuation analyses. And, a buying shareholder may want to know why they are paying more than certain valuation analyses indicate.

While the fairness opinion provider isn’t ultimately opining as to whether a certain price is the best price for their constituent party, they should be prepared to discuss value within the framework of possible value indications and deal prices.

Income Approach—The Use of Projections

The management of a company considering a significant corporate transaction (either as a buyer or a seller) will typically utilize projections in assessing the value of the subject transaction. Projections may be prepared (1) on a stand-alone basis (i.e., irrespective of the proposed transaction) or (2) inclusive of expected synergies from the proposed transaction.

In utilizing such financial projections for the purpose of issuing a fairness opinion, it is important that the financial adviser understands the nature of the projections. The financial adviser should, at a minimum, perform the following procedures:

1. Research the company and its industry.
2. Review historical financial statements of the company.

3. Review historical financial statements and stock prices of guideline companies.
4. Perform financial analyses such as ratio analysis and common size analysis on both historical and projected financial statements.
5. Make an effort to understand (to the extent possible given the detail of the provided information) the underlying assumptions used to prepare the projections.
6. Interview company management to understand the "story" for both the company and the projected financial information.

These procedures have several objectives, including the following:

1. Assessing whether the projections represent results that are reasonably achievable by the company.
2. If the projections are determined to be reasonably achievable, estimating the likelihood (i.e., the risk) in achieving the projected results. Once the financial adviser has made an assessment of the level of risk, the financial adviser can estimate an appropriate present value discount rate to use in an income approach valuation analysis.
3. Assessing whether any estimates of the value of expected synergies are realistic.

What Is Included in the Projections?

At this point, the financial adviser should ask an important question: What is included in—or not included in—the projections? A valuation analysis is only as good as the information on which it is based.

Projections that are too high or too low can result in an inaccurate valuation analysis if the present value discount rate does not reflect the level of risk in the projections.

One school of thought regarding the preparation of stand-alone projections for a prospective transaction is that such projections should be prepared on a conservative basis. Therefore, such projections would not include any "speculative" sources of value.

When (1) reviewing the subject company's historical and projected financial statements and (2) interviewing company management, the financial adviser should learn enough about the company to make an informed judgment as to whether the projections are telling the whole story.

Conversely, in performing these procedures, it is important to make sure that the projections are not overly optimistic. If there are aspects of the business that have historically generated growth and profits, but are for some reason not expected to grow as fast and/or remain as profitable, then the projections should not assume the continuation of historical trends when the current market information suggests otherwise.

A review of growth rates and profit margins is particularly critical in the case of development stage or early-stage companies. In the case of development stage companies, there is often no historical revenue. Therefore, there is only a history of losses.

For early-stage companies, there may be high revenue growth rates accompanied by losses. In either case, there is little historical operating information that is useful for the purpose of analyzing projections.

For a startup company with little historical revenue or profits, the primary indication of value may be projections of these and other financial fundamentals. In addition to reviewing financial indications such as growth rates and profit margins, the financial adviser should make an effort to understand the components of the projections in terms of specific products and services the company intends to provide and sell.

What Is not Included in the Projections?

A review of the projections should also consider what sources of value to the subject company are not included in the projections. The projections may not include sources of value that are available to the target company as a stand-alone entity. These sources of value may include items such as:

1. underutilized or nonoperating assets and
2. additional areas of business to the company.

Underutilized assets might include intellectual property such as:

1. patents that are not currently being used at all or
2. patents and/or trade names that are currently underutilized.

In some cases, these sources of value may be included in (1) projections that include transaction-related synergies or (2) projections for the combined entity (where they might be included in transaction-related synergies). In other cases, there may be sources of value that are not in any of the provided projections.

If the financial adviser identifies these sources of value and is able to determine that these sources of value could be achieved by the target company as a stand-alone entity, this may indicate overly conservative projections (and perhaps an unfairly low price for the proposed transaction).

For an example of stand-alone value not included in projections, let's consider the example of a hypothetical company that makes an electronic market in trading a

certain class of financial security. At the time of a prospective transaction, the company is about to implement advanced new software that will make its services significantly more attractive to its customers. The services will be more attractive by lowering the bid/ask spread for trading securities in the company's electronic market.

This change is expected to allow the company to increase the transaction charge per trade that it charges to its customers. If the projections assume that the company will receive the same amount of revenue per trade that it had historically received, it is possible that a valuation analysis based on the projections can understate the value of the company as a stand-alone entity.

The components of value that may not be reflected in a company's financial projections can be positive or negative. That is, factors not properly considered in the preparation of the projections could lead to understatement as well as overstatement of value.

Synergies

In many proposed transactions, one justification for the transaction is potential synergies between the buyer and seller. Sometimes, synergies are merely expected to be cost savings from the elimination of redundant functions. For example, the merged company will not need two headquarters or two chief financial officers.

Other times, synergies represent factors such as revenue or earnings enhancements that the merged companies would be expected to demonstrate, as compared to the individual companies on a stand-alone basis.

Another category of possible synergies relates to possible differences between the two companies. For example, let's consider a situation where the buyer has a lower cost of capital than the target. In this case, merely applying the buyer's cost of capital to the stand-alone projections of the target will result in a higher estimate of value (as compared to using the target's cost of capital).

A comparison of stand-alone projections and projections incorporating expected transaction-related synergies may include estimating how the value of the projected synergies should be allocated among the parties. This allocation can manifest itself in the following two ways:

1. The difference between stand-alone projections and combined projections may suggest which parties are assumed to bring the subject synergies to the table.
2. The proposed transaction price might reflect which party receives the benefit of the synergies. For example, if the indicated purchase price is similar to the stand-alone value indications of the seller, this suggests that the buying shareholders (and not the selling shareholders) will reap the benefit of the projected synergies.

Sometimes synergies cannot unambiguously be attributed to one party or the other. One example of this is the case of the selling company that has a net operating loss (NOL) carryforward. An NOL carryforward can be applied against future earnings, reducing the taxable income (and therefore the income taxes) of the subject company.

If the selling company has an NOL carryforward, but it is projected to incur operating losses in the future, it may not be able to utilize the NOL carryforward. In that case, the NOL carryforward is of little value to the seller on a stand-alone basis.

However, the purchasing company may be able to utilize the NOL carryforward, in which case it may have significant value (but only to the combined company). In this case, there is no clear answer as to how this benefit should be allocated among the parties to a transaction.

Sensitivity Analysis

An important procedure in performing income approach valuation analyses for a fairness opinion is to perform a sensitivity analysis. In a sensitivity analysis, value is estimated while changing one or more assumptions to the valuation model. The assumptions that are subject to sensitivity analysis include (but are not limited to) factors such as growth rates, discount rates, and profit margins. In fact, almost every input to a typical discounted cash flow model can be analyzed using a sensitivity analysis.

The sensitivity analysis will allow the users of the model to estimate the effect of possible inaccuracies (such as underestimating or overestimating the appropriate present value discount rate) in the selection of the assumptions tested. In using a sensitivity analysis, the financial adviser should consider the effect of varying each assumption with the perceived uncertainty in estimating that assumption.

A sensitivity analysis can also be considered from the perspective of analyzing whether the subject assumptions are considered to be conservative, "base case," or aggressive.

Market Approach—The Use of Guideline Companies

The marketplace is often considered the best place to estimate and test values. Fairness opinion analyses almost always include one or more market approach value indications. These market approach valuation analyses often compare the subject company to guideline companies that are (1) publicly traded and/or (2) merged and acquired.

These market approach valuation analyses are often a key point of focus for the fiduciaries that seek fairness opinions. This is because transactions in the securities of other

industry participants are an obvious and easily understood benchmark against which to compare the subject transaction.

A company's historical financial statements may not reflect the company's operations going forward. The financial adviser should (in conjunction with company management) prepare normalized historical financial statements to account for these factors. These factors may include (among others):

1. eliminating areas of business that are not expected to recur and
2. adjusting margins to reflect an expected change in market conditions.

As mentioned above, fairness opinion valuation analyses typically do not estimate a single value conclusion based on the different valuation approaches and methods used. These fairness opinion analyses do, however, present several value indications.

Each of the valuation approaches and methods uses, in turn, valuation pricing multiples derived from several guideline companies. It is possible that the pricing multiples (and therefore the implied values) from these individual guideline companies will vary considerably.

For the purpose of presenting a fairness opinion, it is helpful to analyze the individual companies in order to understand which of these companies is expected to provide the most useful pricing information for the subject company. For each individual company, the factors analyzed should include both (1) quantitative factors (such as growth rates and profit margins) and (2) qualitative factors (such as an understanding of the expected changes in the industry and the company's operations).

A thorough investigation of the individual companies used in these market approach valuation analyses will enable the fairness opinion presenter to discuss:

1. which value indications are most applicable to companies in the subject transaction and
2. the reasons that certain value indications are not as relevant to the subject transaction.

Market Approach—Transactions in the Securities of the Subject Company

One of the most reliable indications of the value of any asset is prior sale transactions related to the subject asset. In the case of prior transactions in the common stock of a company subject to acquisition, the financial adviser should make sure that the precedent transactions were, in fact, arm's-length sale transactions.

In making this determination, the financial adviser should consider several factors.

1. The relationship between the parties.

   The further apart the relationship between parties to a precedent transaction in the subject security, the more likely it is that the transaction can be determined to be arm's-length. However, even transactions between seemingly close parties can be considered to be arm's-length if other conditions are met.

2. How the price was determined.

   The methods used to determine the price of a precedent transaction can help indicate whether the transaction was arm's-length. For example, if the price was set by an independent, uninterested third-party valuation firm, it is more likely that the transaction was arm's-length.

   If the price was determined by a formula (pursuant to a buy-sell agreement or a shareholder agreement), the financial adviser should analyze factors such as (a) the age of the formula and (b) whether the formula provides for reasonable updates to account for the passage of time.

3. The existence of any compulsion.

   If either the buyer or seller were under compulsion, it may be less likely that the transaction was arm's-length.

4. Whether the parties were informed.

   When the parties to a transaction were more informed, the transaction was more likely to have been arm's-length. The opposite is not necessarily true: less informed parties do not necessarily indicate that the transaction was not arm's-length.

5. Whether the price was subject to negotiation.

   A negotiated price is more likely to be arm's-length. The negotiations may be current (related to the price of the precedent transaction) or historical (perhaps related to the negotiation of a formula to set a price for transactions in the subject security).

Other Factors to Consider

In summarizing the valuation analyses related to fairness opinions, this discussion has focused on income approach and market approach valuation analyses. This is because these valuation approaches are most often relied upon in estimating the value of an operating company.

In any valuation or fairness opinion assignment, it is a good practice to utilize as many valuation approaches and methods as one can. The use of several valuation approaches and methods can result in mutually supportive value indications.

The financial adviser should therefore consider using the asset-based approach when performing a fairness opinion if the necessary information is available to estimate the value of the subject company's intangible assets. In addition to providing an additional indication of value, the use of the asset-based approach will aid in the identification of the subject company's intangible assets.

In some cases, the value indications from certain valuation approaches and methods will differ significantly from the proposed deal price. At first glance, this may indicate that the proposed deal price is in fact unfair to one party or the other. However, there may be one or more factors that represent significant differences between (1) an ownership interest in the subject company and (2) ownership interests in the benchmark companies or benchmark data used under the valuation approaches used.

These benchmark companies may be (1) guideline companies used in the market approach and/or (2) companies used to estimate the industry risk premium or beta in the income approach.

For example, for many closely held companies engaged in the wholesale distribution industry, the companies have distribution agreements with their suppliers that are not transferable to another owner. In effect, the owners of the company can't actually "sell" all of the company's assets.

From an asset perspective, the value of an operating company is comprised of tangible assets (such as working capital and fixed assets) and intangible assets. These intangible assets can include one or more of customer relationships, vendor relationships, trademarks and trade names, intellectual property (e.g., patents and copyrights), and other intangible assets in the nature of goodwill.

If the sellers can only in effect sell the tangible assets, then the sale price will most likely be less than the value indications from market approach and income approach valuation analyses. In the market approach guideline publicly traded company method, the fact that the guideline company is publicly traded in effect allows the shareholders to sell all of the company's assets (and not just its tangible assets).

This doesn't mean that the deal price is unfair. Rather, it means that the market approach valuation analyses might not reflect all of the relevant factors needed to determine whether the price is fair.

Bring-Down Fairness Opinion

A traditional fairness opinion is provided when a deal is proposed. There may be a time difference of up to several months between the initial fairness opinion presentation and the actual approval of or closing of the transaction. In some cases, the fiduciary that requested the fairness opinion will want to get an updated a fairness opinion (known as a bring-down fairness opinion).

A bring-down fairness opinion will need to address one or both of (1) changes in the terms of the proposed deal and (2) changes in market conditions. If either or both of these have changed against the interests of the party to whom the fairness opinion is addressed, then the fairness opinion provider should be prepared to explain why the deal is or is not fair.

The potential difference in market conditions between (1) the initial fairness opinion presentation and (2) the time that the deal is approved or closed is especially relevant given recent market conditions. With financial markets demonstrating unprecedented volatility, the financial adviser cannot merely "plug in" updated valuation data (such as guideline company stock prices and current interest rates) without considering whether this information accurately reflects current valuations.

Summary and Conclusion

Ultimately, fairness is an opinion, and not a statement of fact. This is also the case with valuation. Since a fairness opinion is based on valuation analyses, the reliability of a fairness opinion can rise or fall depending on the strength of the underlying valuation analyses.

This discussion summarized the factors to consider when performing a valuation analysis for a fairness opinion. All of the considerations that a financial adviser should apply in the normal course of a valuation analysis also apply in preparing a fairness opinion.

In addition, the financial adviser should be aware of other factors specifically related to a fairness opinion that need to be considered. This will enable the preparation of a fairness opinion that can withstand scrutiny.

Notes:

1. For the purpose of this discussion, a constituent may be either (a) those who are giving up consideration, (b) those who are receiving consideration, or (c) a party that is not directly giving up or receiving consideration, but the value of whose holdings may change in the proposed transaction.
2. American Society of Appraisers, Business Valuation Standards—Definitions.
3. Source: Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 4th ed. (New York: McGraw Hill, 2000), p. 30. Original source *The Dictionary of Real Estate Appraisal*, 3rd ed. (Chicago: Appraisal Institute, 1993), p. 190.
4. Delaware General Corporation Law, Subchapter IX, Section 262(h).

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