

Viewpoint on Value

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Is the price right?

Cover all the bases with a fairness opinion

When a company is about to embark on a major transaction — such as a merger or acquisition — having an objective outsider review the numbers to ensure management has covered all of the bases is key. Fairness opinions do exactly that. They state whether the price offered in a transaction falls within a range of fairness — from a financial point of view.

A fairness opinion doesn't endorse a proposed transaction or substitute for internal due diligence, nor is it required by law or statutory authority. But it does assure managers, minority shareholders, lenders and other stakeholders that a transaction appears fair from an objective point of view.



Embraced by private companies

Although the landmark Delaware Supreme Court case *Smith v. Van Gorkom* didn't mandate fairness opinions for major transactions, it did validate them as a way for boards of directors to demonstrate reasonable business judgment. Many public companies subsequently have used fairness opinions to defend themselves against possible lawsuits and investor criticism.

Of course, fairness opinions don't provide absolute guarantees against legal challenges, particularly if management engages in fraud or other unethical behavior. But they do help demonstrate that directors acted on an informed basis, in good faith, in a manner they reasonably believed to be in the best interests of the company and its shareholders, and without fraud or self-dealing.

Customarily, a board of directors obtains a fairness opinion, but anyone — including buyers, managers, lenders, trustees and minority shareholders — may find it useful to obtain one. Private companies can also reap benefits from fairness opinions.

Fairness is frequently relevant

Although most often used in mergers and acquisitions, fairness opinions may also prove beneficial in other situations, including:

- Divestitures and spin-offs,
- Leveraged buyouts,
- Treasury stock purchases,
- Corporate restructurings or refinancing,
- Going-public (or private) transactions,
- Employee stock ownership plans, and
- Bankruptcy reorganizations.

A fairness opinion is especially important when a transaction is complex or likely to receive opposition from disgruntled minority shareholders or creditors. Further, a fairness opinion provides added protection when related parties — such as corporate affiliates or top executives — have financial incentives that conflict with other stakeholders' priorities. For example, a fairness opinion makes sense if the company is undergoing a management buyout or if the CFO's employment contract includes a substantial change-in-control bonus clause.

Some loan covenants specifically require fairness opinions if the borrower engages in a transaction with an affiliate above a prescribed dollar amount. These covenants protect lenders from fraudulent conveyances that may compromise the lender's position in default or bankruptcy.

The means to an end

In many ways, the processes underlying fairness opinions are similar to those used in traditional business

valuations. Fairness opinion providers review many of the same documents, including historic financial statements, shareholder agreements, management forecasts and business plans. They also conduct site visits and management interviews.

In addition, fairness opinion experts employ the same three valuation techniques — the cost, market and income approaches — to estimate a range of reasonable values for the company (or other asset involved in the transaction). But valuation may be just the tip of the iceberg. Experts also may consider the transaction's financial structure, the consideration's type and timing, future accounting implications, and the deal's tax consequences.

For example, the consideration exchanged in an acquisition might include cash and convertible preferred stock in the combined entity. Evaluating the fairness of this hypothetical deal would require an additional investigation into the buyer's financial position.

It's also possible that compliance with an accounting standard — such as FASB Statement No. 141, *Business Combinations* — might unexpectedly reduce a merged company's future earnings per share. By anticipating these unintended consequences, fairness opinions can help reduce forthcoming opposition.

What to expect

There is no standardized format for fairness opinions, but most contain:

- A description of the transaction, including the parties, date, consideration and terms,
- A summary of the expert's procedures and analyses,
- A list of sources used to evaluate the transaction,
- A statement of assumptions and limiting conditions, and
- A conclusion statement (“fair” or “unfair”).

If an expert dubs a proposed transaction “unfair,” it's likely that management will think twice before moving forward. In most cases, the parties renegotiate the terms — or walk away from the deal — if the price falls outside the expert's range of reasonable values. ■

INDEPENDENCE IS KEY FOR FAIRNESS OPINIONS

Public companies traditionally turn to their investment bankers for fairness opinions. But investment bankers' independence has come under attack in recent years.

Some analysts and stakeholders believe that financial incentives — such as “success fees” and ongoing financial relationships — could cloud investment bankers' objectivity when issuing fairness opinions.

The National Association of Securities Dealers (NASD) responded to these allegations with a probe into the fees, methods and independence issues related to fairness opinions. The pending changes call for enhanced fairness opinion disclosures to help stakeholders identify potential conflicts of interest.

Proactive stakeholders needn't wait for SEC approval. Many companies are choosing independent valuers for their fairness opinions. You should ask the following questions to determine whether any potential weaknesses might compromise a fairness opinion's reliability:

- Was the fairness opinion provider a financial advisor in the proposed transaction?
- Does the fairness opinion provider have a prospective financial interest in any of the parties to the transaction, such as contingent fees, ongoing service contracts or postdeal financing arrangements?
- Will top executives receive any bonus payments on closing?
- Was the fairness opinion provider given adequate time and access to information to perform a comprehensive analysis?
- Did management dictate methods or unreasonably limit the fairness opinion provider's procedures?
- If the fairness opinion provider relied on management's assumptions and financial projections, do the contents appear reasonable? Did the expert independently verify internally generated financial information?

Selecting an experienced, objective fairness opinion provider — one without a stake in the deal — can dramatically improve the perceived reliability of fairness opinions.

Analyze this: An overview of financial statement analysis

Financial statement analysis is an important part of every valuation assignment. By benchmarking a company against its competitors and itself over time, the valuator gauges risk and estimates expected return.



4 financial performance components

A comprehensive financial analysis addresses four components of a company's financial performance:

1. Profits. To evaluate profitability, valutors may track revenues, gross margins, operating cash flows, net income, or earnings before interest, taxes, depreciation and amortization (EBITDA). Growth — in terms of revenues, earnings and assets — is another important consideration.

All else being equal, companies that demonstrate steady, positive profitability and growth generally are more attractive to investors than those in decline or showing erratic trends. But unprofitable companies

are rarely valueless. It's important to recognize that financial statement analyses review *historic* performance, which may reflect future expectations. Consider, for example, a promising startup venture that's currently in the red — but is projected to turn a substantial profit within three years.

2. Liquidity. Liquidity measures assess whether a company has sufficient cash and other current assets to meet its short-term obligations. Companies with excess liquidity are better positioned to weather unexpected events and economic downturns.

Working capital — the difference between current assets and current liabilities — is one way to gauge liquidity. Another popular liquidity metric is the current ratio (current assets divided by current liabilities). High working capital and current ratios equate with high liquidity and low credit risk.

3. Activity ratios. Common activity ratios that measure operating efficiency include:

Total asset turnover (annual sales / average total assets). This ratio estimates how many dollars in sales the company is generating from each dollar in assets. It assesses productivity and reveals underused or nonoperating assets.


Accounts receivable turnover (annual credit sales / average accounts receivable). This metric estimates how quickly a company collects its trade receivables. It may reveal lax collection efforts or excessive bad debts.

As an alternative to calculating the number of times receivables turn over each year, some analysts prefer to show the average days outstanding — which typically is calculated by dividing 365 days by the accounts receivable turnover.

Inventory turnover (annual cost of sales / average inventory). With the exception of service businesses, inventory is often a major balance sheet account. Excess inventory can strain cash flow, take up storage space and risk pilferage, obsolescence or damage. As with receivables, inventory turnover sometimes is

calculated as days-in-inventory (365 divided by inventory turnover).

4. Capital structure. How a company chooses to finance its operations — via debt or equity — can have a significant impact on risk. Valuers typically use debt-to-equity and debt-to-total-assets ratios to evaluate financial risk.



An inferior ratio in one industry may be exceptional in another sector.

Although debt initially costs less than equity and offers tax advantages, the benefits of leverage are limited. At some point, leverage becomes cost prohibitive. The most efficient businesses strike a balance between debt and equity called the “optimal capital structure.”

When computing financial ratios, valuers apply formulas consistent with benchmarking data sources. For instance, some sources may use year-end receivables (rather than average receivables) to compute turnover. Or they may use 360 days (instead of 365 days) to calculate days outstanding.

No absolutes

In financial analysis, few hard and fast rules apply. An inferior ratio in one industry may be exceptional in another sector. For example, a current ratio of 2.0 is typically the norm in auto or other manufacturing companies. But in some service businesses with minimal inventory, such as hair salons or investment trading companies, the current ratio may be closer to 1.0.

Some metrics may act as both a blessing and a curse. Quick accounts receivable turnover, for example, typically indicates that management is staying current with collections and bad debts are minimal. But it may also mean that the company’s credit policy is unduly strict and hindering sales.

Financial analysis affects value

Financial statement analysis is more than a rhetorical exercise. It has a direct impact on a valuator’s final conclusion.

Consider a company with below-average profits, declining sales and inadequate working capital compared with its competitors. To account for this hypothetical company’s relatively high risk, a valuator might select a pricing multiple from the lower end of the guideline comparables. Or the valuator could increase the company-specific component of the cost of capital when applying the income approach. At the opposite end of the spectrum, a comprehensive financial analysis might reveal additional value. For example, a company with excess liquidity might warrant an addback to the valuator’s preliminary value for excess working capital.

Financial analysis also may facilitate other parts of the valuation process. For instance, preliminary financial statement analysis can help prepare a valuator for site visits and management interviews by highlighting irregularities and potential risk factors.

Something to consider

A company’s value is determined by investors’ expectations about its future performance. Historic financial statements often provide a glimpse of what the future may look like. But the insight provided by financial statement analysis is only as transparent as the financial data on which it’s based. ■

BACK TO THE FUTURE

For comparative purposes, financial statements should be prepared in accordance with Generally Accepted Accounting Principles (GAAP) and industry accounting conventions. Deviations may skew or invalidate a valuator’s analysis. Because many companies prepare and use income-tax-based statements, it’s important to make adjustments as needed to obtain objective and useful financial information.

This peril is especially common among unaudited private firms. In some cases, valuers may adjust financial statements — for example, for unconventional accounting treatment, quasi-business expenses or nonrecurring items — to obtain the clearest possible understanding of future expectations.

Whodunit — and how much is at stake?

When a company is a victim of a civil wrongdoing — such as breach of contract, negligence or patent infringement — profits frequently suffer. Courts may award monetary damages to make the injured party “whole” again.



In most jurisdictions, it's the plaintiff's responsibility to provide the court with financial data on which to base damage awards. Plaintiffs may provide written damage calculation reports and verbal expert witness testimony. But defendants can protect their financial

interests by providing separate damage calculations or issuing rebuttal reports in response to the plaintiffs' estimates.

Interrelated variables

Estimating damages starts with a basic theoretical position: *If not for Mr. Smith's breach of contract, ABC Co. would have sold more units.* Experts refine their theory as they review financial evidence. In this case, a damages expert might estimate the quantity of lost sales and the incremental profit per unit. He or she also would take into account the length of time the company sustained the loss.

Many variables factor into an expert's damage calculation, including:

Operating history and industry trends. A company's operating history — or that of its competitors — often provides insight into future performance. For example, a valuation expert might track a company's historic gross profit trends using regression analysis. Damages may be quantified as the difference between actual results and what may have been expected based on regression analysis, discounted to its net present value.

Valuation variances. Similarly, a company's value may decline following a tortious act. The expert may

quantify damages as the value impairment resulting from the defendant's actions.

Offsetting external factors. In any damage calculation, the valuator considers the extent to which external factors — such as poor economic conditions or obsolete technology — impaired performance.

Mitigating factors. Most jurisdictions require plaintiffs to attempt to mitigate damages. Valuation experts evaluate whether management took all possible steps to minimize losses.

Tax issues. The objective in any damage case is to make the plaintiff whole again. So as part of the estimate, a valuator considers whether the plaintiff's damage award will be subject to state and federal taxes.

Recipe for disaster?

Some companies attempt to minimize court costs by calculating damages themselves and providing their own in-court testimony. A recent Tenth U.S. Court of Appeals case demonstrates the perils of do-it-yourself damage calculations.

In *Chavez Properties–Airport Parking Albuquerque L.P. v. Lorentzen*, one of the partners in an Albuquerque Airport parking lot joint venture was found liable for various transgressions that reduced the partnership's profits.

Plaintiff-partners testified regarding lost profits. Because this testimony contained many errors, it provided an inadequate basis on which to calculate lost profits. Accordingly, the court awarded just \$1 in damages.

In addition to having a financial interest in the outcome of the case, the plaintiffs were unfamiliar with the nuances of business valuation. If they had engaged a qualified, objective valuation professional, they might have increased this nominal award.

Professional guidance

Many of the same principles that underlie business valuations are important in damage calculations. For

example, both types of assignments may rely on discounted cash flow, guideline companies, benchmarking and financial statement analyses.

In civil wrongdoing litigation, damages usually center around the testimony or valuation reports

of the experts representing both sides of the case. Experienced valuation professionals not only offer unbiased opinions, but also understand complex financial issues, relevant case law, and the ins and outs of serving as an expert witness. ■

4 KEY IRS RULINGS AT A GLANCE

The Treasury Department periodically issues revenue rulings to help interpret tax laws. These interpretive rulings don't carry the same weight as the Internal Revenue Code, but they do clarify complex or ambiguous topics — including business and intangible asset valuations. The most noteworthy valuation-related revenue rulings include:

1. Revenue Ruling 59-60. Issued nearly 50 years ago, this ruling is considered landmark precedent that has withstood the test of time. In addition to providing the most-cited definition of fair market value, this pronouncement identifies eight factors to consider when valuing a closely held corporation:

- The nature of the business and its history,
- The general economic and industry outlooks,
- The company's book value and financial condition,
- The company's earnings capacity,
- The company's dividend-paying capacity,
- Goodwill or other intangible value,
- Previous sales of stock and size of the blocks, and
- Market prices of comparable stocks.

Revenue Ruling 59-60 also advises valuers to consider the effect of restrictive shareholder agreements on stock value, but only if they represent bona fide business arrangements.

2. Revenue Ruling 68-609. The Treasury Department originally created the excess earnings (or formula) method to estimate the intangible value of breweries and distilleries during prohibition. This ruling discusses the underpinnings of the excess earnings method but states that it "may be used for determining the fair market value of intangible assets of a business only if there is no better basis available."

3. Revenue Ruling 77-287. In 1977, the IRS officially recognized restricted stock studies as a source of empirical evidence for marketability discounts. This ruling discusses various types of restricted securities and the SEC's *Institutional Investor Study*, which identifies four factors that influence marketability discounts: earnings, sales, trading market and resale agreement provisions.

Revenue Ruling 77-287 lists other factors — such as previous offers, trading volume, shareholder relationships and elements of control — to consider when quantifying marketability discounts.

4. Revenue Ruling 93-12. Until 1993, minority interests transferred for gift and estate tax purposes were typically subject to family attribution. This ruling reversed the family attribution rules and allowed minority discounts on partial interest transfers regardless of the parties' family ties.

These rulings may be cited in valuations prepared for nontax purposes, including divorce and shareholder disputes. So it's important to understand these pronouncements before relying on a business valuation for any purpose.

John M. Leask II (Mac), CPA/ABV, CVA, values 25 to 50 businesses annually. Often, Mac's valuations, oral or written, are compiled in conjunction with the purchase or sale of a business, to assist shareholders prepare buy/sell agreements, or to set values when shareholders purchase the interest of a retiring shareholder. Here are examples:

- **Due Diligence & Assist with Purchase of a Business.** Mac has assisted purchasers of businesses by determining or reviewing the offer. He helps negotiate the price, perform due diligence prior to closing and/or helps structure and secure financing. Services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to future success, and helping management plan future operations.
- **Family Limited Liability Partnerships, Companies & Closely Held Businesses.** Mac regularly values various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuers.

Mac also helps business owners and their CPAs and/or lawyers in the following ways:

- Planning — prior to buying or selling the business
- Prepare valuation reports in conjunction with filing estate and gift tax returns
- Plan buy/sell agreements and suggest financing arrangements
- Expert witness in divorce & shareholder disputes
- Support charitable contributions
- Document value prior to sale of charitable entities
- Assist during IRS audits involving other valuers' reports
- Succession planning
- Prepare valuation reports in conjunction with pre-nuptial agreements
- Understanding firm operations & improving firm profitability

More information about the firm's valuation services (including case studies) may be found at www.LeaskBV.com.

To schedule an individual consultation or to discuss any other points of interest, Mac may be reached at 203 - 255 - 3805. The fax is 203 - 380 - 1289, and e-mail is mac@leaskBV.com.

If you have a business valuation problem, Mac is always available to discuss your options — at no charge.



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