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BUSINESS VALUATION UPDATE

Vol. 23, No. 11, November 2017

TIMELY NEWS, ANALYSIS, AND RESOURCES FOR DEFENSIBLE VALUATIONS

Key Valuation Considerations for Fairness Opinions

Fairness opinions are frequently finding their way into a courtroom, so it is important to have a grasp on both the legal and financial aspects. Craig Jacobson and Richard Peil, who are both with GlassRatner Advisory & Capital Group, and attorney Jeffrey Rothschild (McGuireWoods LLP) provide a valuable list of valuation and legal issues to consider when performing a fairness opinion,[1] which is summarized below.

Legal framework. At the outset, understand the legal framework for a fairness opinion assignment in the relevant jurisdiction. For example, the standard of value sometimes is fair market value, and sometimes it is not. In the Delaware Court of Chancery, where many stockholder disputes are adjudicated, there is a very specific definition of the fair value standard of value, which precludes consideration of three issues: (1) discounts for marketability; (2) discounts for lack of control; and (3) in appraisal actions, stockholders are not entitled to the synergistic benefits of any prospective transaction.

Due diligence. When you render a fairness opinion, you will likely give a presentation to the board or special committee. Make sure you have performed your due diligence procedures and analyzed the company and the transaction from a qualitative and quantitative point of view. You're probably going to be questioned during the presentation, so make sure you really know and understand the company's business and how it relates to the underlying valuation analyses supporting the fairness opinion. One question you will get is whether or not you interviewed management, so be ready to explain that. At the outset, make sure that you have adequate time to do your work and perform your due diligence.

Normalization adjustments. Consider normalization adjustments for discretionary expenses and nonrecurring items. One important thing is the normalization adjustments for nonrecurring charges must also be considered in the context of your guideline companies. Frequent examples of this are differences in accounting policies, such as for inventory. If your target company is a retailer, confirm that all the guideline companies in your peer group use the same inventory and accounting method as the target company. When analyzing private M&A transactions, it will be more difficult to get data. However, to the extent possible, you must evaluate the factors that would lead you to confirm a selected transaction provides sufficient data to properly evaluate transaction multiples.

Discount rate and projections. Buyers are often thinking in terms of how much the target company is going to earn in the future, which is shown by a discounted cash flow (DCF) analysis. Projections are very important because they often reflect the analytical process by which buyers entering into a transaction take into consideration. A common valuation error is a mismatch of discount rates and the risk inherent in the projections. One must understand the discount rate is a long-term measure because a significant portion of risk, associated

1 Fairness Opinions: Best Practices + BVR Gives First Look at New Research Tool, BVR webinar (Aug. 10, 2017); sub.bvresources.com/bvstore/cd3.asp?pid=CD552.

with a DCF analysis, is contained in the terminal value. For example, if using the Gordon growth or similar model to calculate the terminal value, the discount rate should reflect the target company's risk in perpetuity, not just the period of the discrete cash flow projections.

Guideline companies and transactions. A common mistake is that analysts don't choose the proper peer group companies. It is a significant problem because the choice of peer group companies is receiving an increasing amount of scrutiny in contested valuations. Analysts should be diligent in their selection process and dig deeper into available financial information, such as 10-Ks.

Analysts frequently evaluate the most basic valuation multiples of recent revenue or earnings. However, it's important to confirm there is a correlation between systematic market risk of the target company relative to the peer group companies. Regarding guideline M&A transactions, more recent transactions will be more relevant than older transactions. It is also important to understand certain other elements of a transaction, such as who was the buyer—was it a financial or strategic buyer? In addition, was the transaction due to the company's financial distress or other duress?

Industry and general economic data. No company exists in a vacuum, so make sure that you've considered the industry and general economic conditions in which the target company operates. This is especially important if there is uncertainty in securities prices. Don't ignore current asset prices when you're doing any kind of valuation assignment. That's particularly important when you're rendering a fairness opinion related to a transaction.

Discounts. Many fairness opinion valuation subjects are marketable interests. The definitions of fair value that might apply in a fairness opinion specifically preclude the marketability consideration. But it is important to consider, at the entity level, whether something might restrict the sale of the company as a whole. Also, consider

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Business Valuation Update™ (ISSN 1088-4882) is published monthly by *Business Valuation Update*™ (ISSN 2472-3657, print; ISSN 2472-3665, online) is published monthly by Business Valuation Resources, LLC, 111 SW Columbia Street, Suite 750, Portland, OR 97201-5814. Periodicals Postage Paid at Portland, OR, and at additional mailing offices. Postmaster: Send address changes to *Business Valuation Update (BVU)*, Business Valuation Resources, LLC, 111 SW Columbia Street, Suite 750, Portland, OR 97201-5814.

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New Database Debuts for Benchmarking Fairness Opinions

With the absence of regulation surrounding the issuance of fairness opinions, market practices become de facto standards. Business Valuation Resources (BVR) is launching its new product, the Fairness Opinion Research Service (FORS), that enables professionals to easily know "what's market" and benchmark their work against hundreds of board books, proxies, and fairness opinion letters filed at the SEC over the last five years.

"With FORS, practitioners access relevant documents through an efficient and intuitive interface that saves them countless hours spent tracking down filings," says Renaud Selmès, CTO of BVR. Most importantly, with FORS, users can screen this unique source of information using more than 40 criteria. Screening criteria include usual suspects such as target's industry, name, size, and location as well as participants such as counsel and opinion issuers. Profession-specific screening criteria include items such as multiples, WACC, and terminal value calculation methods.

"By using technology based on visualization and drag-and-drop, BVR provides practitioners with a premier user experience to instantly access fairness opinion data ranging from valuation summaries to advisory fees," says Selmès. For more information, go to www.bvresources.com/products/fairness-opinion-research-service.

the jurisdiction when developing discounts. For example, the Delaware Court of Chancery is frequently critical of a company-specific risk premium because it is regarded as overly subjective and subject to manipulation.

Fee structure. Contingency fees represent a potential conflict of interest in an opinion-only engagement. Confirm that your engagement letter states the fee is payble regardless of the conclusion and whether a transaction is consummated. In addition, your engagement letter should state the fee is due and payable when you are prepared to render an opinion, not when you actually render it.

This list touches on the highlights and is certainly not exhaustive. Jacobson, Peil, and Rothschild delve into much greater detail during a BVR webinar, Fairness Opinions: Best Practices + BVR Gives First Look at New Research Tool (Aug. 10, 2017). The new research tool is BVR's Fairness Opinion Research Service (see the sidebar for more information). You can access a recording of the webinar at sub.bvresources.com/bvstore/cd3.asp?pid=CD552. ◆