

The Increasing Use of Fairness Opinions in Middle Market Transactions

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For publicly traded companies, the use of fairness opinions in mergers and acquisitions is a fairly standard practice. While not as prevalent in the middle market, fairness opinions are increasingly common in private-company deals. In this paper we explore four scenarios where fairness opinions are potentially beneficial in middle market transactions and also differentiate a fairness opinion from other types of valuations, such as appraisals.

Fairness opinions are typically recommended in a transaction when the execution of fiduciary duty is at issue. The majority of these situations are transactions involving publicly held companies, whose shareholders' interests are represented by the board of directors.

For private companies in the middle market, the need for a fairness opinion arises in more specific circumstances. Such a situation might include the sale of a target company with an employee stock ownership plan (ESOP). Other likely scenarios where fairness opinions may be appropriate include the sale of a company with dispersed, multi-generational ownership, a target company with a trust holding shares, or when a private equity firm is considering divesting a controlling interest where there are significant holdings by the former shareholder(s).

Professional evaluations of the fairness of an offer, known as fairness opinions, are increasingly being requested and used in private company transactions. In this paper we will explore four scenarios in middle market transactions when a fairness opinion may be recommended and differentiate a fairness opinion from other forms of valuations.

Figure 1. Summary of Key Situational Factors

	ESOPs	Multi-Generational Family Holdings	Trusts Holding Shares for Beneficiaries	Control Recapitalizations
Voting Representative:	ESOP Trustee	Primary Family Representative	Trustee	Majority Shareholder
Who is Represented:	Employee Members	Family Member Shareholders	Trust Beneficiaries	Minority Shareholder(s)

Before we look at these likely situations for a fairness opinion in private, middle market transactions, we'll consider some of the differences between a fairness opinion and the more common appraisal.

Fairness Opinions vs. Appraisals

Valuation is a generic term that refers to any form of financial analysis with the aim of quantifying the value of assets/liabilities or securities. The valuation process can manifest itself in several types of work product, but in the context of a corporate transaction, the fairness opinion and the appraisal are often the two most likely analyses performed.

Fairness Opinion

- Tests the current value of a company to compare against an offer so as to evaluate financial fairness of the offer
- Comparative analysis based on appropriate valuation methods
- Results in an opinion letter but is often reflected in a more visual presentation
- Often prepared for the board of directors or special committee thereof
- Prepared to assist in satisfaction of fiduciary duties

Appraisal

- Tests the current value of a company under prescribed conditions and assumptions
- Comparative analysis based on appropriate valuation methods
- Characterized by more methodological and reporting standards, such as USPAP
- Often prepared for benchmarking purposes or to satisfy financial or tax reporting requirements

Transactions That May Benefit From a Fairness Opinion

As noted above, there are specific situations where a fairness opinion can be particularly beneficial in private, middle market transactions.

1) Employee Stock Ownership Plans (ESOPs)

In an ESOP, the employees of the company typically receive stock holdings in the company as part of their compensation for work performed. Shares are held in trust until the employee retires or leaves the company, at which time the shares are sold. A trustee is designated to represent the interests of the ESOP trust and votes in business matters on behalf of the ESOP trust and its employee beneficiaries.

When an offer for purchase or a merger is made, the trustee must exercise fiduciary duty on behalf of the ESOP. In these transactions, the risk of dispute can be higher than a private company deal involving just one or two shareholders. A fairness opinion can help demonstrate that fiduciary duty was executed in good faith and can reduce the chance of shareholder disputes resulting from the transaction.

2) Multi-Generational Family Holdings

In many closely-held family businesses, there can be multiple family members who hold shares in the company. These shareholders often cross generational lines – sometimes spanning several generations and geographic locations. Although many (or most) family members are not engaged in the daily operation of the business, they may hold differing opinions as to the value of the company and have different interests in the outcome of a transaction.

In some family businesses, not every individual with a financial interest in the company may be eligible to vote on the terms of a proposed transaction. Combined with the dispersion of interests, this increases the potential for disagreements to escalate.

Board members may secure a fairness opinion as a way to demonstrate an offer was evaluated with the assistance of independent financial experts.

3) Trusts Holding Shares on Behalf of Beneficiaries

In some instances, a trust may be set up to hold ownership of company stock for beneficiaries. This is often a mechanism to hold corporate profits for heirs and serve as a wealth transfer vehicle.

In these situations, a trustee is designated to vote on behalf of the trust (and ultimately the trust's beneficiaries). The trustee then has a fiduciary duty that must be maintained and demonstrated in the context of a transaction.

Any transaction that shifts or changes control of a private company where shares are held in trust can pose an increased risk of dispute, particularly if the beneficiaries have little or no management responsibilities. As with other similar transactions, the exercise of fiduciary duty can be supported by securing a fairness opinion to provide an assurance as to the financial fairness of the deal.

4) Private Equity Firms Exiting Control Recapitalizations

The need for fairness opinions also impacts private equity firms, particularly those who have made control recapitalization investments in companies. The control "recap" allows the private equity firm to purchase a controlling stake in a company while often leaving former controlling shareholder(s) with substantial equity interests.

This control recap gives the private equity firm a controlling interest in the company, but leaves a substantial shareholder in play. While this might be financial or strategically prudent at the time of investment, in a subsequent sale, the process of separating financial interests can be made more complicated. This is particularly true if there is a disagreement between the majority and minority shareholder(s) about the terms of a transaction. Again, the fairness opinion can help demonstrate the exercise of fiduciary duty to better withstand subsequent challenges.

Common Methodologies of Financial Analysis for Fairness Opinions

Selected Companies Analysis

Compares the operating and valuation metrics for public "peer" companies to those of the target company. A number of criteria can be used to identify public peers, including industry classification, diversification and growth characteristics, in order to establish market pricing for the subject company.

Precedent Transactions Analysis

Similar to a selected companies analysis, a transactions analysis focuses on identifying relevant valuation multiples but relies on whole company transactions as opposed to public share prices. Several criteria can be considered in selecting the transactions used in the analysis and the advisor must strive to find the closest matches and consider prevailing market conditions.

Discounted Cash Flow Analysis

The discounted cash flow methodology is based on the premise that a company's future cash flow, discounted to present value, represents an "intrinsic" value for the company. This analysis relies on expectations of future financial performance, and less on upon public market or transaction multiples. Accordingly, this analysis serves an important role as a valuation method less swayed by market conditions that can be volatile or cyclical.

How Fairness Opinions Differ

By definition, a fairness opinion is a professional evaluation performed by a third party with specific financial expertise such as an investment bank or valuation firm. The goal of the analysis is to evaluate whether the terms of a merger, acquisition, buy back, spin-off or going private transaction are financially fair. It is typically comprised of two pieces: the formal opinion letter and a presentation of relevant data and methods underlying the analyses on which the opinion is based.

Legal counsel for the target company most often recommends the use of a fairness opinion, but buyers' legal counsel may also insist on one to protect the company and its future owners from shareholder claims.

Here, "fairness" is a term that speaks to the financial fairness of the offer, as of a specified date, while considering a set of assumptions and context. The opinion does not assert that an offer is the best price possible for the target company, nor does it imply a recommendation of the transaction.

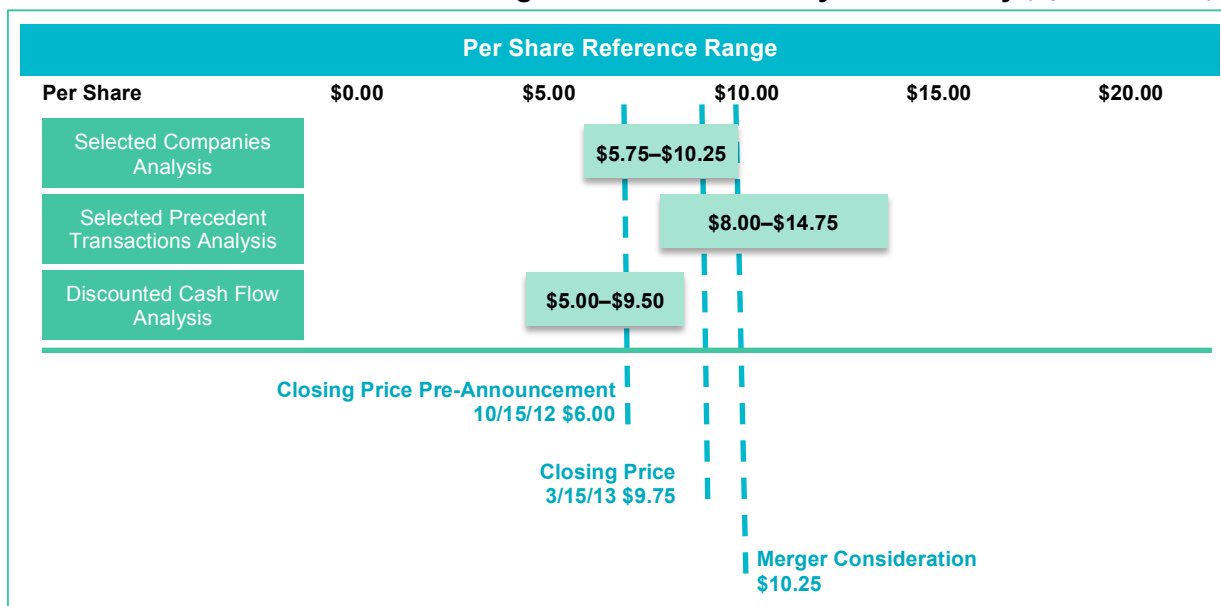
In order to provide a fairness opinion, the financial advisor typically conducts a series of analyses using accepted and/or appropriate methodologies. The financial summary is often a graphical comparison of the value ranges indicated by each of the respective methodologies. [See Figure 2.]

The financial analysis summary charts the resulting valuation ranges for each of the selected methodologies, in comparison to the current offer or merger consideration to show where the offer fits in relation to those valuation ranges. Graphically, support of the financial fairness of an offer is represented by the offer falling within or above the resulting valuation ranges.

Primary Uses of a Fairness Opinion

- I. Assist the board of directors in the decision-making process
- II. Demonstrate prudence and execution of fiduciary duty
- III. Provide a line of defense in the event of litigation

Figure 2. Financial Analysis Summary (\$ per share value)



Value of an Independent Advisor

Uncertainty of the adequacy of the deal price, dispersion of perceived company value among the shareholders, and the risk of future litigation with those shareholders are just three of the obstacles to successfully completing a deal. Securing a fairness opinion can mitigate the severity of many of these obstacles to the successful completion of a proposed transaction.

There are different financial advisors who can prepare fairness opinions. Though the sell-side investment bank may be an obvious choice, there are also advantages to selecting an independent advisor to provide a fairness opinion.

An independent advisor who is not financially invested in the outcome of a transaction can provide an unbiased fairness opinion that may better withstand a future challenge in a dispute. It is beneficial to be able to show that the opinion was produced without potential conflicts of interest. If the advisor has a substantial interest contingent on a transaction's consummation, there may be real or perceived conflicts that could be used to discredit the opinion in a future dispute.

Additionally, when selecting an advisor to prepare a fairness opinion, choosing an advisor familiar with the dynamics of the company's industry can also be beneficial. There are often nuances or trends within an industry that can have a significant impact on the valuation of a company. Finally, when selecting an advisor, inquire about the testifying experience of the individual who will ultimately be responsible for defending the fairness opinion to potential litigation counterparties. A meaningful investment in a fairness opinion from a reputable firm is worth substantially less if the person assigned to this task does not know or recall the bases for the opinion or whose lack of testifying experience creates unnecessary legal exposure.

Key Takeaways

There are a number of situations where fairness opinions play an important role in middle market transactions. Even on the buy-side of a transaction, it is prudent to be well versed in the needs and requirements of the sell-side in order to better predict a positive outcome for the deal.

A few key items for business owners, executives, directors, investors and trustees to keep in mind when entering a deal that involves a change of control for the target company include:

1. Existence of fiduciary duty is usually a key indicator that a fairness opinion may be beneficial in a transaction;
2. A fairness opinion is often a protection mechanism for future litigation;
3. Finding an advisor who is knowledgeable of the industry and the litigation process are important considerations in choosing a fairness opinion provider; and
4. Avoid real or perceived conflicts that can reduce the defensibility of a fairness opinion by engaging an independent advisor.

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