Valuation Concepts

inside:

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Mirror, mirror on the wall, is this transaction fair at all?

Proposed NASD rule change targets fairness opinions

A fairness opinion is a statement from an independent expert that a proposed transaction appears "fair" from a financial point of view. Fairness opinions do not assess legal or structural fairness, nor do they serve as an endorsement for management's decision to pursue a proposed transaction.

Nonetheless, fairness opinions have grown increasingly popular in recent years while also drawing their fair share of regulatory scrutiny.

Why to obtain one

Although no statutes or regulations currently mandate fairness opinions, they can help managers, directors and stakeholders feel more confident in due diligence performed in a variety of corporate control transactions, including:

- Mergers and acquisitions,
- Equity recapitalizations,
- Bankruptcy reorganizations,
- Leveraged buyouts,
- Initial public offerings, and
- Going-private transactions.

Fairness opinions also give added peace of mind if management has limited experience with similar types of analyses or transactions. In fact, loan covenants sometimes require management to obtain a fairness opinion for major transactions.

What to expect

When assessing fairness, financial experts typically estimate a range of reasonable values. The ceiling of this fairness range represents the highest price a reasonable buyer would willingly pay in the proposed transaction.

Conversely, the floor is the lowest price a rational seller would accept. As long as the transaction price falls within this range, the expert concludes that the deal appears fair from a financial perspective.

The format of a written fairness opinion letter can vary, depending largely on the time available and the scope

of the expert's analyses. At minimum, fairness opinions usually include:

- A description of the proposed transaction,
- An effective date,
- A description of the scope of the engagement and the procedures performed,
- A listing of key assumptions and limitations, and
- A statement of the expert's ultimate fairness conclusion (such as "fair" or "unfair").

Unfair opinions are rarely published, however. Instead, when an expert dubs a proposed transaction "unfair," the board usually goes back and renegotiates the terms — or walks away from the table.

To help managers, directors and investors get more from fairness opinions, many experts attach addenda to their letters that detail the analyses supporting their opinion. Additionally, some providers supplement their written reports with oral presentations that conclude with question-and-answer sessions.

How to spot conflicts

Fairness opinions recently have come under attack for their perceived lack of objectivity. Whether real or perceived, independence issues compromise a fairness opinion provider's reliability and integrity.

Conflicts of interest are particularly problematic when a transaction's investment banker or business broker provides the fairness opinion. After all, these parties often have a significant financial incentive to complete the transaction.

For example, investment banks customarily receive substantial "success fees" at closing. Similarly, the brokerage fee charged by a broker may be contingent on the selling price. Some investment banks also provide posttransaction "staple" financing for the buyer.

Other potential conflicts could result from ongoing consulting, underwriting, lending, research or asset management fees the fairness opinion provider might receive after the deal closes.

What the NASD thinks

In 2004, the National Association of Securities Dealers (NASD) initiated a probe into the fees, methods and independence issues related to fairness opinions. As a result of its study, the NASD revised Rule 2290.

Disclosures under revised NASD Rule 2290

The investigation into fairness opinions conducted by the National Association of Securities Dealers (NASD) led the organization to propose that, under revised Rule 2290, its members should disclose:

- Whether a fairness opinion provider acted as a financial advisor in the proposed transaction,
- Whether the fairness opinion provider will receive any compensation that is contingent on the successful completion of the transaction,
- Any material relationships within the last two years (or contemplated in the future) between the fairness opinion provider and the parties to the proposed transaction,
- Any financial information the company supplied to the fairness opinion provider (such as financial projections, growth rates, cost of capital estimates and synergies) that may have formed a substantial bias in the fairness conclusion, and
- Whether the fairness opinion provider independently verified any information provided by the company.

The revised rule also requires NASD members to adopt and disclose internal review procedures for fairness opinions.

The revisions would require enhanced disclosures for fairness opinions provided, described or otherwise referenced to public stockholders — even if not included in proxy materials. (For more details, see "Disclosures under revised NASD Rule 2290" below.)

In April 2006, the Securities and Exchange Commission (SEC) issued the draft version of revised Rule 2290 and invited comments through May 2006. If the SEC approves the revised version of Rule 2290, it will become effective 30 days after the NASD notifies its members of the approval. As of this writing, the SEC was still considering the NASD changes.

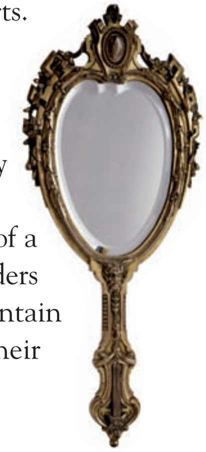
How it all plays out

Critics of the proposed revisions to Rule 2290 contend that the NASD does little to improve perceived conflicts of interest. For example, the revised rule does not prohibit investment bankers from providing fairness opinions for their own deals, require firms to independently verify financial information or underlying assumptions, or prescribe specific methods for evaluating fairness.

Moreover, the details of required disclosures are limited. To illustrate, NASD members are required to describe — but not necessarily quantify — contingent payments or future consulting fees.

Ultimately, Rule 2290 has limited application. It doesn't govern private transactions and applies only to NASD members. Yet because fairness opinions have historically been more prevalent among public securities transactions, NASD recommendations may represent best (or most common) practices for both public and private fairness opinions.

What's more, fairness opinion providers who ascribe to a lower standard of disclosure and internal review procedures may no longer satisfy the expectations of management, investors, lenders or the courts.



Where to go from here

Despite increased regulatory scrutiny, fairness opinions probably won't go the way of the Edsel anytime soon. Thus, regardless of their professional affiliations or the size of a prospective deal, all fairness opinion providers must stay atop recent developments to maintain the perceived reliability and relevance of their expert reports.

Better late than never

FASB issues long-awaited fair value standard

The Financial Accounting Standards Board (FASB) finally unveiled Statement No. 157, *Fair Value Measurements*, in September 2006 — more than two years after the release of its exposure draft in June 2004. This important development affects how appraisers approach fair value — as opposed to fair *market* value.

Fair value vs. fair market value

In Statement 157, FASB defines fair value as:

> The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

For comparison purposes, Treasury Revenue Ruling 59-60 defines fair market value as:

> The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.

FASB's definition of fair value is similar to conventional definitions of fair market value in many ways. Both standards represent an exchange price between informed, unrelated entities. And both assume a customary exposure period to the market before the measurement date. Moreover, neither buyers nor sellers are under compulsion to transact, as is the case in a forced liquidation or distress sale.

Beyond semantics

Although similar in many respects, there are several key differences between fair value and fair market value. For instance, fair value focuses on the perspective of the market participant that holds the asset or owes the liability. In other words, fair value estimates an exit (rather than an entry) price.

Accordingly, in Statement 157, FASB includes restricted stock discounts and transportation costs for location-specific assets (such as commodities) in its definition of fair value. FASB considers transaction costs to be an entity-specific cost of entry and, therefore, it specifically excludes them from fair value estimates.

Another difference between fair value and fair market value lies in the prospective pool of buyers and sellers. Appraisers typically interpret fair market value to represent an all-encompassing "universe" of hypothetical buyers and sellers.

Conversely, fair value considers only market participants active in the principal (or most advantageous) market from the perspective of the reporting entity, which may vary among entities owning similar assets but operating in different industries.

In other words, fair value assumes a pool of strategic buyers that can exploit the asset to its "highest and best use." Moreover, fair value includes generic synergies available to all market participants but excludes buyer-specific synergies, which FASB categorizes as goodwill for financial reporting purposes.

A three-tiered hierarchy

Similar to the Treasury's definition of fair market value, Statement 157 recognizes three methods of estimating fair value: the market, cost and income approaches. But Statement 157 also establishes a three-tiered hierarchy for calculating fair value:

1. Most favored is quoted prices in active markets for identical assets and liabilities.

2. Just below that, FASB recommends using observable market prices for similar assets and liabilities — better known as the market approach.

3. FASB least favors relying on cost and income approaches that use unobservable inputs.

So, if there are identical or comparable market prices for an asset or a liability, Statement 157 generally eliminates the need for appraisers to consider the cost or income approaches.

Observable inputs

Although FASB favors observable inputs over unobservable ones, sometimes real-life transactions don't represent fair value. Thus, companies cannot automatically assume that a transaction price (an entry price) represents fair value (an exit price).

Although exit and entry prices often converge, several situations can cause a difference. For example, a transaction price may not represent fair value if:

- The parties are related,
- The seller is under duress (perhaps due to financial difficulties),
- The transaction price includes transaction costs, buyer-specific synergies, control premiums, or other unstated rights and privileges (which should be valued separately), or
- The transaction occurs in a market different from the entity's principal (or most advantageous) market.

As is evident, the subtle — but important — differences between fair value and fair market value underscore the importance of seeking outside appraisal expertise for financial reporting purposes. Although Statement 157 strives to clarify fair value measurements, practical applications remain subjective and complex.

The unfortunate minority

Technically, Statement 157 is effective for fiscal years beginning after Nov. 15, 2007, and for interim periods within those fiscal years. But, because it builds on existing reporting requirements, it is immediately relevant.

More than likely, Statement 157 will not have a material effect on most companies' financial statements. But it will require an unfortunate minority to substantially alter their current valuation methods and disclosures. A qualified appraiser can help you determine into which group your business falls.

M&A is no place for DIY

Appraisers bring valuable expertise to the buy-sell process

Try this new twist on an old adage: "Anyone who acts as his own M&A consultant has a fool for a client."

Few business owners would dare to represent themselves in a legal proceeding, yet a surprising number take the do-it-yourself (DIY) approach to buying or selling a private business. And those who do often come to regret this decision.

Beware the risks

How do you buy or sell a business? This may seem like an elementary question. But unless a prospect or offer falls into your lap, getting the ball rolling can be a daunting task.

And even if you find the perfect acquisition target or receive an unsolicited offer, how do you know you're getting a good deal? What are the tax implications?

Could an alternate deal structure lower your future tax bill? Are the company's financial statements reliable and accurate?

Whether you're a buyer or seller, the M&A process is complicated. Moreover, as buyers and sellers invest time and energy into a prospective transaction, their attitudes often shift from objective and realistic to emotional and out of touch with economic reality.

Inexperience and emotion have no place at the negotiating table. Misinformed sellers risk underpricing the business or failing to reach all prospective buyers. They may also be blindsided by unexpected posttransaction tax liabilities. Conversely, buyers may overpay, for instance, because of unrealistic synergies or misleading financial information.

Perhaps worst of all, without an advisor to guide them, buyers and sellers may become frustrated with the M&A process and abandon their investing or divesting aspirations altogether.

Respect the advantages

An appraiser can help coordinate the M&A process from start to finish. More specifically, he or she can:

Evaluate the buy/sell decision. Today might not be the best time to buy or sell a business. An objective financial professional analyzes industry supply and demand trends and determines whether a buyer's or seller's market exists.

He or she can also brainstorm alternatives to buying or selling a business. For instance, a business owner strapped for cash might consider recapitalizing equity to achieve imminent liquidity needs. Or a company might consider in-house expansion rather than acquiring a competitor to tap into new markets or add product lines.

Prepare the business for sale. Experienced appraisers understand what buyers want — and what they don't. They can suggest ways to maximize selling price and to help sellers assemble a portfolio of financial information to solicit offers.

Establish a range of reasonable values. Buyers and sellers frequently have unrealistic ideas about business values, possibly based on outdated rules of thumb or unfounded rumors about the sales of competitors.

The right appraiser will know the inner workings of real-life transactions — either first hand or from private transaction databases — that can serve as the basis for pricing a business for sale or putting together an attractive offer package.

Without an advisor to guide them, buyers and sellers may become frustrated with the M&A process and abandon their investing or divesting aspirations altogether.

Facilitate due diligence. Prospective buyers want to "kick the tires" before signing on the dotted line. An appraiser can help analyze financial information, confirm account balances, conduct site visits and interview management.

From the seller's perspective, confidentiality is key. Appraisers can screen prospective buyers for unwanted or unqualified buyers, as well as managing information requests and limiting the potential for premature disclosure.

Structure the deal. Appraisers know how to help buyers and sellers understand the tax consequences of proposed transactions and suggest creative alternatives to minimize taxes or to achieve other objectives.

Deal structure can include a host of creative terms, such as earnouts, seller financing, installment sales, escrow accounts, consulting contracts and noncompetes.

Pick the right expert

Business appraisers are the logical go-to people for objective M&A advice. Unlike business brokers, whose fees are traditionally contingent on the successful completion of the deal, appraisers' fees are typically fixed or based on an hourly rate. Thus, there's no incentive to push through imprudent transactions or to maximize selling price at all costs.

Divvying up goodwill in divorce cases

The term "goodwill" in a divorce context typically refers to all intangible value. Yet unlike cash, receivables, equipment and other hard assets, intangibles are more difficult to value and to equitably split between former spouses.

A recent Louisiana appellate case, *Gill v. Gill*, embodies the view of the majority of courts on divvying up goodwill.

The Gills' goodwill

When the Gills decided to divorce, the court had to weigh in on the respective value of the couple's two private businesses:

1. A funeral home. In 2001, the Gills jointly purchased a funeral home for $375,000, which the husband managed as funeral director and embalmer. The parties stipulated that the value of the funeral home's buildings and lot was $250,000 but disputed the remaining value of the business.

Using the income approach, the wife's expert appraised the business at $490,000, including the real estate. But the trial court rejected her appraisal because it included the company's future income, which was "uniquely tied to [the husband's] personal skills."

Alternatively, the husband's appraiser valued the business at $307,155, which included the real estate and $57,155 for the company's net book value. Another 2001 appraisal was also submitted into evidence that valued the business at $408,000. (The court opinion does not indicate who submitted it.)

The court rejected all appraisal evidence and, instead, used the previous purchase price of $375,000, which was $67,845 higher than the husband's asset-based appraisal. The appellate court affirmed the trial court's value and ruled, "This excess value can be attributed to the goodwill of the established business which the Gills had acquired during their marriage."

2. A CPA practice. The wife and her previous husband had worked together as accountants until his death in 1998. She continued operating her CPA practice throughout her marriage to Mr. Gill.

The appellate court rejected the trial court's classification of the CPA practice as community property. Although the court agreed that the wife's business income was community property during the marriage, it concluded that the value of the CPA practice rested "almost exclusively on [the wife's] professional skill and earning power. Other than accounts receivable, which the parties resolved by agreement, there was no other increase in the tangible assets of the business."

The majority view

In its review, the appellate court in *Gill* opines that judges "may include goodwill in valuing any community-owned corporate, commercial or professional business. However, that portion of goodwill attributable to any personal quality of the spouse awarded the business shall not be included in the value of the business."

Indeed, this opinion does appear to reflect the majority view nationwide. Courts in more than half of the states specifically exclude personal goodwill from marital estates. In fact, charges of "double dipping" are often levied in situations in which the nonmonied spouse receives credit for both personal goodwill and the monied spouse's future income via support payments.

Then again, some jurisdictions make no distinction between personal and business goodwill. Instead, the marital estate may include (or exclude) goodwill in its entirety. Others have not yet issued a formal ruling on this subject.

No simple matter

Valuing goodwill in divorce cases is no simple matter. In the absence of prevailing case law, divorce courts sometimes look to other jurisdictions for guidance. Therefore, not only is the case law of the state in question important, but what's going on across state lines may also be relevant.